

Feb. '49

The New York
Certified Public Accountant



VOL. XIX

February • 1949

No. 2

Auditors' Responsibilities and the Law
Sell and Lease Transactions
Inventory and Material Commitments
Scrutiny of Financial Statements by Credit Men
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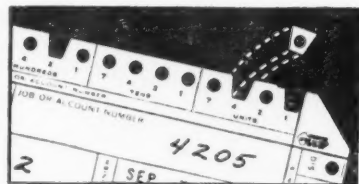
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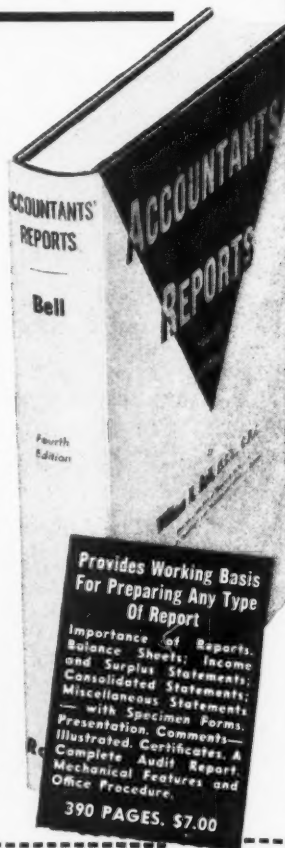
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BOOK REVIEWS

Understanding the Securities Act and the S.E.C.

By Edward T. McCormick. AMERICAN BOOK COMPANY, New York, N. Y., 1948. Pages: viii + 327; \$7.50.

By reason of his long and varied experience on the staff of the Securities and Exchange Commission, the author brings real familiarity with his subject to his objective of explaining in considerable detail the principal problems that the careful registrant must recognize and solve in the course of obtaining an effective registration of securities. The explanation is interspersed with a sufficient variety of illustrations, drawn from actual cases and actual registration statements, to lend point and reality, if not always charm, to the discussion—of which more later.

The text consists of two main divisions, the longer of which is entitled "Interpretation of the Securities Act of 1933" and consists of a section by section analysis of the Act, and more important, of the Commission's interpretation of such concepts as "security," "issuer," "underwriter," "exempt transaction," "exempt security" and the like. To those who have not had occasion to deal extensively with registration of securities for public flotation under the Act, the detail of this section will prove highly valuable. To those familiar with the process, there is still much to be gained from analysis of the points emphasized by an administrator of the Act.

The second principal, and unfortunately shorter, section is captioned "Disclosure under Securities Act of 1933" and consists of a resume of the formal opinions of the Commission and of positions taken in letters of deficiency in some seventy odd registrations. The discussion of formal opinions approaches, of course, a "chamber of horrors" display. The discussion of deficiency letters, although including many extreme cases, also includes illustrations of solutions apparently worked out more or less mutually in the face of conflicting facts and philosophies and, accordingly, approaches much more closely the type of situation which a prospective, responsible registrant is apt to encounter. The section will be most useful as a check list of things not to be done and of the probable extent of necessary disclosure in the situations mentioned. As a practical matter, disclosure requirements are not any more static than are economic conditions; as a result, some, at least, of the solutions presented appear al-

ready to have been outmoded by more recent developments.

The remainder of the text is devoted, first, to a short summary of the historical background of securities legislation and, second, to a summary critique of proposals to amend the Act. A final most helpful section includes a bibliography of writings in the field.

No first comprehensive invasion of so extensive a field can possibly satisfy all of the desires of all of those who may expect to obtain enlightenment therefrom. To have covered so much in so few well written pages is in itself a remarkable achievement. Two fields do suggest themselves as fruitful additions. It would have been most helpful had there been a discussion and summary of what might be called the "most common" or "standard" deficiencies. It would also be desirable to expand the disclosure section so as to include a wider coverage of more recent, less extreme examples—that is, of recent illustrations less striking and horrendous and more common-place and familiar. For example, of the opinions and registration statements chosen, about four-fifths of the opinions and nearly half of the registrations occurred in the earlier, formative years of the Commission's life. Four-fifths of the opinions and one-fourth of registrations dealt with the extremes of promotional companies.

From a strictly accounting point of view, there are fewer accounting illustrations than might have been expected, since the disclosure section deals with opinions and deficiencies as to financial statements in less than twenty pages. There are, however, a number of statements in the forepart of the book which the accounting profession will certainly wish to think about and seriously. One or two quotations will be illustrative:

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(Continued on page 87)

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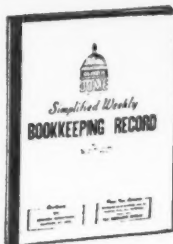
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Book Reviews

(Continued from page 85)

the financing program of obtaining 'acceleration' is so great that the registrant readily recognizes the advisability of eliminating from its registration statement the omissions or inaccuracies cited by the Corporation Finance Division in its 'letter of deficiencies'. The Commission is thus in a position to 'enforce' compliance with its views as to what constitutes full and fair disclosure in individual instances."

"... If a statement is true when made, but the registrant learns prior to the date when the registration statement becomes effective that the statement is untrue, the statement must be corrected if the registrant wishes to avoid liability under Section 11 or administrative action under Section 8(d)."

"... The expression by the independent accountant of his opinion as to the propriety of the accounting practices and policies of the issuer is a statement of a material fact."

WILLIAM W. WERNITZ

New York, N. Y.

Auditing Procedure (Revised Edition)

By Paul E. Bacas, Arthur H. Rosenkampff and William Wider. THE RONALD PRESS COMPANY, New York, N. Y., 1948. Pages: ix + 625; \$5.00.

This is the revised edition of a previous book written by Messrs. Bacas and Rosenkampff. The major changes are described by the authors in the preface as follows:

"The authors have condensed somewhat the material in the first edition relative to the new junior and to the office of the public accountant. Additions have been made throughout to give effect to audit procedures developed in recent years. Two chapters have been added to develop certain procedures which apply to large engagements. Another chapter has been added to discuss the detailed procedures which appear in the Bulletins published by the American Institute of Accountants.

"Problems were issued in a separate pamphlet when the first edition was published. Questions taken from past C.P.A. and American Institute examinations have been added, and these problems are now submitted at the end of each chapter of this book."

The opening chapters discuss and illustrate various general matter such as Auditing, Its Nature, The Public Accountant, System of Automatic Internal Audit (commonly referred to by accountants as system of internal control), Working Papers, Audit Routine (four chapters devoted to a discussion of footings, extensions, postings, trial balances, confirmations, sales invoices, cash sales, examination of vouchers, etc.), Understanding

with Client and Audit Program. The remainder of the book deals principally with the necessary auditing procedures in connection with the verification of the items appearing on a balance sheet and profit and loss statement and a discussion of certificates and reports. The concluding chapters are devoted to special matters of an advanced nature.

The review questions and problems at the end of each chapter represent an excellent method of enabling the student to test his knowledge of the topic discussed therein.

At the conclusion of each chapter there are also a series of review paragraphs; the authors have very ably set forth the purposes thereof:

"The purpose of the review paragraphs at the close of each chapter is to assist the student in determining whether he has digested the material in the chapter and whether he understands and remembers its significance. If the student reads a review paragraph and does not recall the subject matter, it is advisable that the material in question should be read again."

Although this book is designed primarily, and is ideally suited, for the student, the practicing accountant will also find it an excellent reference volume.

BENJAMIN NEUWIRTH

New York, N. Y.

Montgomery's Federal Taxes—Corporations and Partnerships (1948-1949)

By Robert H. Montgomery, Conrad B. Taylor and Mark E. Richardson. THE RONALD PRESS COMPANY, New York, N. Y., 1948. Two volumes, pages: xii-1011 + 887. \$20.

This latest edition of MONTGOMERY'S FEDERAL TAXES—CORPORATIONS AND PARTNERSHIPS has probably already been placed on the library shelves of most tax practitioners. It has been a standard working tool of lawyers, accountants, and corporation executives interested in Federal income taxes for more than a quarter of a century and this edition continues its high standard of usefulness to the profession. But if the old users need not be reminded of its worth certainly those who have not yet used it need to know its value, and this review is primarily intended for the guidance of those who are seeking a complete and convenient summary of current tax laws and practices.

This work is much more than a summary of the law and regulations. Indeed, its peculiar value lies in the many forthright statements of the authors' views on various tax problems. The reader who turns to its pages for light on some unfamiliar problem will, however, find a brief direct statement of the pertinent law, regulations, ruling and cases

(Continued on page 89)



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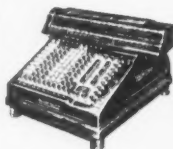
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Book Reviews

(Continued from page 87)

(together with an extremely lucid explanation of their meaning) and if he seeks only this type of information he may stop at that point. If he continues his reading, however, he will be richly rewarded, for it is in the authors' questioning of interpretations and the pointing out of danger spots in certain courses of action that this book offers its greatest help. Adequate quotations from court decisions are given wherever they are likely to prove helpful. The arrangement of the chapters is logical and can be easily followed without the study of any special system of classification. The index and the various tables afford a valuable aid in locating any type of information in the text, whether it is sought in the listing of the appropriate word or phrase in the alphabetical index or located through one or more of the various finding lists of Internal Revenue Code sections, regulations, rulings and court decisions.

In addition to dealing exhaustively with all of the tax problems of corporations in general, including administrative procedures, the work includes a section on consolidated returns and a very valuable study of present-day Federal income tax problems of partnership. The latter is still a timely and an important subject despite the "split income" provisions of the 1948 Revenue Act, especially in view of the Bureau's questioning attitude toward even brother and brother partnerships.

This year's edition does, however, omit the material relating to excess profits tax relief claims which was included in earlier years, inasmuch as the authors feel that there have been relatively few important developments in this field during the past year.

The experienced practitioner turns to the pages of Montgomery to check his own reaction to a tax problem by assuring himself that no aspect of the problem or any significant ruling or decision has been overlooked. If the problem is a novel one to him, no better place can be found for obtaining a clear understanding of the background of the tax questions involved than in the pages of this work. Hence, both the professional and the business man will find Montgomery's book of great value.

An enormous amount of tax knowledge is presented in these two relatively small volumes. Such a compilation reflects many lifetimes of tax experience and practice as well as many years of study, not only on the part of the authors and their present associates, but of all those who collaborated in the preparation of the past editions of the present text. Only through such long-continued growth and evolution has such a compilation of tax law, combined with clear interpretation and wise counsel, come into being. Colonel Montgomery and his associates are to be congratulated on continuing to make this invaluable aid available to all who are seri-

ously concerned with today's most perplexing problem—how much of the profits still left to corporations by the unions will they have to share with their not-so-silent partner—Uncle Santa.

PAUL D. SEGHERS

New York, N. Y.

Montgomery's Federal Taxes—Estates, Trusts and Gifts (1948-49)

By Robert H. Montgomery and James O. Wynn. THE RONALD PRESS COMPANY, New York, N. Y., 1948. Pages: xiv + 1263; \$10.

Once again, we have enjoyed the privilege of reviewing the current annual edition of this standard work on the federal taxation of estates, trusts and gifts.

Although legislative revisions of the Internal Revenue Code, enacted by Congress during 1948, introduced novel and far-reaching changes in the tax pattern for married people in all fields encompassed in this volume, they have all been fully reflected in the text. Indeed, to insure completeness, the proposed amendments to Reg. 105 (Estate Tax) and Reg. 108 (Gift Tax), which were not released until Nov. 5, 1948, too late for incorporation in the main text, have been included in the Appendix. It is the authors' opinion that, although they are tentative and subject to change, they will ultimately be promulgated in substantially the same form. In similar vein, the authors have also made references to the Revenue Revision Act of 1948, (which was passed by the House but not considered by the Senate before adjournment) as indication of possible legislative changes in the law.

The basic plan of the book remains unchanged, viz.,

Part I—Methods of Estate Distribution

II The Income Tax on Decedents, Estates and Trusts

III The Estate Tax

IV The Gift Tax

Appendix

Indexes

The first part has been rewritten to reflect the effect upon methods of estate distribution of the statutory changes brought about by the Revenue Act of 1948. The second part contains a new chapter on the *Clifford* doctrine. The sections on the estate tax and the gift tax have likewise been appropriately revised and brought up-to-date. The same excellent typography and method of indexing and cross-referencing are continued, as heretofore.

The same old refrain is once again just as true as it was before: It is this reviewer's opinion that this book is an indispensable part of the library of all practitioners in the field of fiduciary taxation.

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VOL. XIX

February • 1949

No. 2

Auditors' Repensibilities and the Law

By BORIS KOSTELANETZ, C.P.A.

THE legal responsibility of the accountant to his client and to others is never a pleasant subject of contemplation. In a society which demands of

one performing a service an ever increasing number of duties with ever higher standards for their performance, its importance in terms of practical business considerations for the accountant is a far cry from the relatively little concern it caused a few years ago. Litigation, while still at a very low level, is an always present threat. Its worrisome, distracting and expensive consequences are all too familiar. Added to these is the distressing uncertainty of what an average jury, without technical knowledge or accounting experience, may do with the evidence presented to it in appraising the accountant's conduct in terms of negligence, gross negligence and of a rather special type of fraud. As a group, accountants seem to have become, at the jury's hands, the victims of their reputation for professional competence.

"The natural tendency of jurors," once said the late Victor H. Stempf, "unfamiliar with accounting is to regard the auditor as one charged with infallibility and to resolve the facts, on hindsight, far too rigidly."¹

This discussion of the New York auditor's liability is not intended for the theoretician.² Emphasis will be placed, therefore, on those aspects of the subject which seem to be of the greatest practical every-day value: the

BORIS KOSTELANETZ, C.P.A., has been a member of the Society since 1936. He was graduated from New York University, receiving the degree of B.C.S. in 1933, and from St. John's University School of Law with the degree of LL.B. (*magna cum laude*) in 1936. He is an Adjunct Professor in Accounting and Taxation at New York University Graduate School of Business Administration.

Mr. Kostelanetz, a member of the New York Bar, was formerly Special Assistant to the Attorney General of the United States in charge of the War Fraud Section, and the Chairman of an Interdepartmental Committee on Tax Evasion and Black Markets. Previously he was an Assistant United States Attorney for the Southern District of New York. While in the Government he prosecuted a number of celebrated cases. He is presently engaged in the general practice of law as a member of a prominent law firm.

¹ Address delivered before the Philadelphia Accounting Forum on May 7, 1942, *The New York Certified Public Accountant*, June 1942, p. 518 at p. 523.

² For background material on the development of liability in the skilled professions and in accountancy especially, see Wiley Daniel Rich, "Legal Responsibilities and Rights of Public Accountants" *Amer. Inst. of Accountants* (1935); Frederick K. Rabel, CPA, "Auditing Standards and Procedures in the Light of Court Decisions" 42 *Mich. L.R.* 1009 (1944).

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law which has so far been developed by the courts,³ and the measures by which the accountant can better guard against liability and prosecution of claims against him for damages.

It should be noted at the outset that the law of auditor's liability is still in the early stages of its growth. Its scope and limits, for several reasons, are necessarily uncertain and not fully defined. While an attempt will be made here to draw some inferences from the decided cases, one must not lose sight of the fact that since the earliest New York decision in 1925, a changing commercial society has been altering earlier concepts and standards.

The substantive law of accountants' liability in New York is to be found in two well considered judicial opinions: *National Surety Corp. v. Lybrand*, 256 App. Div. 226 (1939); and *Ultramares Corp. v. Touche*, 255 N. Y. 170, (1931).⁴ These cases have settled, within reasonably clear limits, the law generally applicable to two types of situations:

- (a) The accountant's responsibility to his client; and
- (b) The responsibility he owes to third parties (creditors, stockholders, etc.) who may rely on his work.

The first of the foregoing relationships had earlier been reviewed in our

state. In *Craig v. Anyon*,⁵ a firm of brokers had a trusted but embezzling employee who covered his thefts by falsifying the firm's books for nearly five years. During all this time the firm employed accountants to make quarterly audits. They failed to discover the defalcations. At the trial, the jury found the defendant-auditors negligent and assessed damages at \$1,177,805.26, the amount of plaintiff's actual loss. But the trial court, which the Appellate Division affirmed, reduced the award to \$2,000. While both tribunals agreed that the defendants had been negligent, they ruled nevertheless that the only damage proximately resulting was the \$2,000 fee paid defendant-auditors for their services. The rationale of this rather novel measure of damages was derived from the defense that plaintiff-clients had been contributorily negligent in the supervision—or lack thereof—over their own malfeasant employee. It is noteworthy, particularly in the light of what was later to happen in the *National Surety* case, that the vote in the Appellate Division giving this defense effectiveness was divided and a strong dissenting opinion filed.

In consequence of the *Craig* decision, accountants felt that they enjoyed a certain immunity from litigation for their own negligence.⁶ As late as 1936,

³ For a review of the law prior to 1936, see address of the late David L. Podell, Esq., of the N. Y. Bar, to the N. Y. State Society of CPA's, published in *The New York Certified Public Accountant*, April, 1937, at p. 31, et seq.

⁴ *State Street Trust Co. v. Ernst*, 278 N. Y. 104 (1938), re-affirmed the doctrine of the *Ultramares* case without substantially adding to the substantive law.

⁵ 212 App. Div. 55 (1925), affirmed 242 N. Y. 569.

⁶ Attention is invited to *O'Neill, et al. v. Atlas Finance Corp.*, 139 Pa. Super 346, 11 A. (2d) 782 (1940). The trial jury had returned a verdict for plaintiff-auditor suing to recover fees for services. Defendant-client admitted that plaintiff was entitled to the fee but had counter-claimed on the ground of the accountant's negligence in failing to discover thefts by defendant's bookkeeper. On appeal, the court upheld the verdict, saying that there was sufficient evidence for the jury to find that plaintiff was not negligent since the audit agreement called only for an examination of the books without verification; that a detailed, complete and certified audit by which the shortages would have been uncovered was not contemplated. The auditor's letter of transmittal stated that the report was unverified and uncertified. A careful statement, therefore, of the contract terms for the work to be performed, and of any letter or certificate describing them afterwards, may avoid the unfortunate consequences resulting from a court applying to vague contract terms the standards for professional performance by an auditor which it might find controlling. Note the language in the *National Surety* case (pp. 233-234) which says that the contracts for services were clear and defendant-auditors were bound to use "reasonable skill and diligence in" performing what the contracts

a distinguished and learned practitioner at the New York Bar was even moved to remark that:

"In the case of the client, if the accountant can show that the client has himself been negligent, he has a defense to any suit for negligence and usually it is not difficult to show that the client has been himself negligent."⁷

In 1939, however, the sense of apparent security generated by the 1925 *Craig* decision was rudely shattered by the opinion of the same court handed down in *National Surety v. Lybrand*, (*supra*). This was another case of liability to the client for negligence in making the audit. As in the *Craig* case, a stock brokerage firm and a trusted but dishonest employee were involved. The latter's thefts covered a period of nine years without detection. Knowing when the audits were to occur the cashier had managed to hide his embezzlements from three firms of accountants successively retained to audit during those years. His system consisted of abstractions from petty cash concealed on ordinary days by delaying and substituting bank deposits, called "lapping"; and when outside audits were made, by "kiting" checks among the firm's bank accounts. The plaintiff surety company paid the brokers their loss, and then as assignee sued all three public accounting firms. Two of the three defendant firms, in reliance on the *Craig* case, set up among other defenses that the proximate cause of the loss was contributory negligence of the brokers themselves. At the close of all the evidence, the trial court took the case from the jury. It dismissed the complaint on its merits, and the surety company appealed.

The Appellate Division, by a 3-2 vote, reversed this judgment, ordering

a new trial. It held that a *prima facie* case for liability had been made out and that the issues of fact, including negligence and contributory negligence, ought to have been submitted to the jury. The opinion was lengthy and contained several very significant observations on the law, the most important of these *dicta* perhaps being:

"It is undisputed that cash in bank can be verified absolutely."⁸

The court also quoted approvingly from accounting authorities that deposits during the last day of an audit period should be tested for "kiting", and that check numbers should be verified. It urged on auditors as well the importance of checking duplicate deposit slips to reconcile actual deposits with book entries.

While some earlier decisions in other jurisdictions as well as some text writers declare that auditors are not the insurers of the accuracy of the accounts which they audit, an affective exception to that point of view appears to exist with respect to "cash in bank".⁹ Regardless of what may have occurred in the course of a fiscal period, the balance of cash in bank, as shown in the financial statement should be in accord with the facts. It is fair to say, and the *National Surety* case is a good example, that where the statement of cash in bank has differed from the facts and litigation ensued, the accountant is a consistent loser. Making "a mere arithmetic bookkeeping computation," is not enough, unless the audit's scope has been clearly limited by the terms of the contract or the certificate.

The effect of the *National Surety* decision upon the contributory negligence defense is undoubtedly paramount. It had been thought that at least the

contemplated without regard to the fact that they may have charged too little for such elaborate services.

⁷ David L. Podell, Esq., *op. cit. supra*, p. 36.

⁸ 256 App. Div. 226, 233.

⁹ Part II of Mr. Rabel's article, *op. cit., supra*, p. 2, Footnote 2, contains a valuable compilation and discussion of American, Canadian and English "Judicial Pronouncements with Regard to Specific Audit Procedures" to 1944. Included are cash in bank, receivables, inventories, securities, liabilities and operating accounts.

client's negligent failure sufficiently to supervise his own trusted employee was a shelter raised by *Craig v. Anyon* over accountants who failed to find the shortage. But note from the following language how the court has limited and redefined the doctrine of contributory negligence as a defense:

"Accountants, as we know, are commonly employed for the very purpose of detecting defalcations which the employer's negligence has made possible. Accordingly, we see no reason to hold that the accountant is not liable to his employer in such cases. Negligence of the employer is a defense only when it has contributed to the accountant's failure to perform his contract and to report the truth." (Emphasis supplied.)¹⁰

The language immediately following this quotation strongly suggests that the only kind of contributory negligence which would be a defense is that which amounts to an interference with the audit's conduct. In effect, the court likens the nature of the auditor's contractual engagement to that related in a Court of Appeals decision where a workman was injured by the dangerous condition he had undertaken to repair.¹¹

While the Appellate Division thus attempts to distinguish *Craig v. Anyon* on its facts, the *National Surety* opinion is actually an expansion of the dissenting opinion in the earlier case when emphasis was placed on the implied contractual obligation of the accountant to protect his client from the consequences of the client's own negligence.

We also find in the *National Surety* case a rejection of the measure of damages which it applied in the *Craig* case. It leaves for the jury to say whether the accountants are liable for not only failing to discover existing defalcations, but also for defalcations subsequent to audit on the theory that further defalcations are made possible through non-discovery.

The other horn of the accountant's liability dilemma is his responsibility to such third persons as stockholders and creditors, past, present and prospective. Prior to the decision in *Ultramares v. Touche*, 255 N. Y. 170 (1931), it had been generally supposed that accountants owed no duty whatsoever to persons who were not their clients. Since there was no contract with third parties, it was queried as to how there could possibly be any responsibility to them. There is none of what lawyers call "privity of contract"—no direct relationship between the accountant and these other persons. In other words, accountants then took the position that even if they were negligent, the only person who had a right to complain was the client who had paid the fee. But the courts, first in the *Ultramares* case, and later in *State Street Trust Co. v. Ernst*, 278 N. Y. 104 (1938) refused to accept this view.

In the *Ultramares* case a balance sheet, prepared by the accountants, had been exhibited to creditors. It showed a business to be solvent when, in fact, it was insolvent. Plaintiff *Ultramares Corp.* granted credit in reliance thereon. The situation in the *State Street Trust Co.* case was substantially analogous.

The holdings of these two decisions may be summarized as follows:

- a. The client may recover from an accountant where the accountant has been negligent;
- b. Third parties (investors and creditors) cannot recover from an accountant where he has been merely negligent;
- c. Third parties (investors and creditors) may recover from an accountant where fraud can be proved;
- d. Gross negligence on the part of accountants is sufficient evidence from which a jury may infer fraud.¹²

The accountant will find it necessary to revise the ordinary concept or con-

¹⁰ 256 App. Div. 226, 236.

¹¹ *Kowalsky v. Conreco Co.*, 264 N. Y. 125 (1934).

¹² See also *O'Connor v. Ludlam*, 92 F. 2d 50 (CCA 2nd, 1937); cert. den. 302 U. S. 758.

notation of the word "fraud" in order to understand the language of the Court of Appeals in these two cases. He must do so for his own protection. This particular species of fraud may be established without evidence of deliberation, premeditation, scheming or culpable motive. It may even be found in the absence of a specific state of mind; and good intentions are no defense whatever. It may be inferred by the trier of the facts merely from the following judicially tabulated negligent conduct, and quite without regard to contributory negligence which is not a bar to fraud liability:

- a. An opinion so flimsy as to lead to the conclusion that there was no genuine belief in its truth;
- b. A representation, certified as true to the accountant's knowledge, where knowledge there was none;
- c. A refusal to see the obvious; a failure to investigate the doubtful, if sufficiently gross;
- d. Heedless and reckless disregard of consequence.

Before passing to a discussion of precautionary measures which an accountant may employ to protect himself, it is well to recall again that the law of auditor's liability, if not still in its infancy, is certainly in its early adolescence. An early guide post, *Craig v. Anyon*, *supra*, has already been limited, distinguished on its facts, and perhaps rejected. Professional standards and practices are crystallizing in a pattern of greater uniformity and receiving more wide-spread acceptance. Coupled with the current trend in all areas of commercial and professional endeavor to stricter legal as well as social responsibility, one may, therefore, reasonably expect that the law's future development will stress an extension and refinement of the accountant's responsibility to the public he serves.

In considering precautions, it is well

to place first emphasis on one which has already been alluded to:¹³ specification by auditor and client of the audit's scope; and careful preparation of certificates and statements made in consequence of the work.¹⁴

Before an accountant can be found liable to his client for negligently performing his services, it is obviously necessary to determine what he had undertaken to do for his fee. In other words, what is the scope of the audit engagement and what duties were imposed by it on the auditor? It is probably true that the cost of auditing will in most cases bear directly on the amount of work to be done. For that reason, an accountant should be most careful that his files contain, if not a formal contract, at least an exchange of correspondence with the client setting forth in as much detail as practicable what the accountant is expected to do. The importance of so safeguarding his interests becomes readily apparent when it is considered that a precise arrangement between practitioner and client may control the result of a later dispute, in spite of expert testimony adduced to prove so-called "accepted standards of audit procedure" in order to discredit the work. Where the agreement is silent, the accountant affirmatively risks that his contract will be found, in the light of such "standards" as may be proved, to have imposed a duty or duties he never believed or intended to be there.

The same precaution naturally applies with equal vigor to the auditor's certificate or other statement as to the results of his work. He should conscientiously ask himself during its preparation whether any representation has there been made which, on the basis of the audit's actual scope and of later possibly adverse disclosures respecting the client's financial affairs, would be a basis for an inference of

¹³ See footnote 6, *supra*.

¹⁴ Although passing reference has been made to the certificate and letter of transmittal, it is believed that these are of sufficient importance in themselves to merit separate treatment.

fraud within the doctrine of the *Ultramarcs* case.¹⁵

Liability insurance, while a kind of passive precaution, nevertheless must be given a place high on the list. It is the kind of precaution which always works. In spite of everything that the accountant may do, a client or a third person who has sustained a loss has the right to bring an action and perhaps even to submit his case to a jury. No one can predict accurately how jurors will react to the evidence; the "accepted standards of audit procedure" they will find to exist, or which witnesses they will choose to believe. Litigation of a claim presents a very real danger that the plaintiff will prevail, and of course, irrespective of the result there is always the expense of defending. To the average practitioner it would appear that the modest cost of this protection is more than off-set by relief from anxiety and possible wiping out of a lifetime's accumulations.

Along with the more extensive judicial definition of the accountant's obligations and the trend to more rigid standards of audit procedure have come important developments in the relations of accountants to surety companies. The American Institute of Accountants and the Surety Association of America, for example, have worked out an agreement of principles generally to govern the insurer's assertion, by right of subrogation, of claims

against Institute members,¹⁶ the major items of which are as follows:

"1. No claim for failure to discover whether any loss, such as is insured against under fidelity bonds, has occurred shall be asserted against members of the American Institute of Accountants in any cases not involving affirmatively dishonest or criminal acts or gross negligence on the part of an accountant.

"2. A committee of three members, appointed jointly by the Institute and the Surety Association, will conduct a hearing when a surety company so requests. If the committee finds the accountant may have been at fault, on the basis of evidence presented, the surety company may then assert a claim against him.

"3. The agreement does not apply when an accountant, by a specific agreement with his client, engages to discover whether any loss such as is insured against under fidelity bonds has occurred."

The foregoing comments have referred purposefully several times to a changing socio-economic philosophy of our times; to the more rigid standards of professional and business conduct and to their not unlikely future judicial expansion, especially in the field of accounting where the law's development has been slow. For that reason the accountant ought to consider how these factors should characterize the approach he makes to his work.¹⁸

In an enlightened approach, further effective protection against claims is to be had. Too often accountants hark back to the words uttered by an English judge more than half a century ago that,

¹⁵ See *Beardsley v. Ernst*, 47 Ohio App. 241, 191 N. E. 808 (1934) in which the certificate stated an opinion as to the correctness of the balance sheet and that its statements were based on information received from the foreign constituent companies of the client. A subsequent stock purchaser's action for fraudulent misrepresentations and damages was dismissed, the court saying that the language of the certificate required the indisputable inference that the accountant had not examined the foreign companies' books; and that fraud was not established when the accountant's certificate clearly shows the foreign companies themselves supplied the data. It should also be observed that the accountant has not yet been held liable for errors as to the legal effect of transactions which frequently must be taken into account in the certificate or other statement. See *O'Connor v. Ludlam*, 92 F.2d 50, *supra*, where the Court considered such an error as an honest misconception and not actionable in fraud.

¹⁶ It is understood that certain surety companies have abstained from full agreement, although indicating their assent to refrain from prosecuting claims against accountants. See note, "Surety Companies Curb Suits Against Accountants," in *The Certified Public Accountant*, September, 1948, pp. 1, 6.

¹⁸ See address of Hon. Jerome Frank (then Chairman of the SEC) entitled "Accounting for Investors," delivered before the Controllers Institute of America, October 10, 1939.

"An auditor is not bound to be a detective or * * * to approach his work with suspicion * * *." ¹⁹

Such criteria no longer govern. The Appellate Division in the *National Surety* case summarily dismissed the suggestion that the auditor was not obligated to be "suspicious." Said the Court:

"Accountants are commonly employed for the very purpose of detecting defalcations * * *,"

thus making it clear that the trend is to impose duties far beyond the making of what the court called mere arithmetical bookkeeping computations.²⁰

How "suspicious" one should be is open to argument. Certainly it is a factor meriting ample consideration in arriving at the terms of any audit engagement—and the fee.

As a final precaution, it should not be lost sight of that in so limited a number of judicial pronouncements, there inheres a real danger in attempting to generalize as to the law. In such a relatively new and unexplored area, the courts and the profession are feel-

ing their way and being guided perhaps more by changing conditions than by either judicial or accounting precedent. The cases already decided may, therefore, be further limited to and distinguished on their own facts as a result of greater knowledge and changing standards.

The accounting profession as a whole has reason to be proud of its record for achievement and integrity. Litigation resulting from accountants' preparation and examination annually of thousands upon thousands of financial statements has been creditably infrequent. Only four cases have so far reached the higher courts of this nation's greatest commercial state. It is doubtful that any other profession can show in this respect a better record, although such a comparison is uncharitable. Despite the law's correspondingly undeveloped state, one may be encouraged by the view that this very lack of development stems from the competence and innate desire for truth and accuracy on the part of the professional accountant.



¹⁹ *In re Kingston Cotton Mill Company*, 2 Ch. D. 279 (1896).

²⁰ Mr. Rabel, *op. cit.*, *supra*, suggests that the better view of the English cases makes the auditor a watchdog rather than a detective, although insisting that he should not rely on a client's employee for anything he can verify himself.

Sell and Lease Transactions

By GEORGE A. GREENBERG, C.P.A.

IN the past few years, the practice of selling all or part of a company's real estate holdings, and simultaneously leasing this property from the purchaser for long periods, has become quite widespread. Although this type of lease agreement has been utilized for many years by railroad companies and similar businesses in connection with leased lines, the use of such arrangements by mercantile and manufacturing organizations has become prevalent only recently. The reasons for such transactions, the inherent ramifications and the diverse nature of the arrangements present many problems. The independent accountant should understand and resolve these problems before he can issue a certified statement for a company which has consummated such a transaction.

Types of Arrangements

The types of "sell and lease" contracts can be manifold and can contain many provisions which may be important for the consideration of the independent accountant. We list below several common provisions of such contracts. This list is by no means all-inclusive, nor does each classification stand alone, since many of these provisions may be incorporated in the same contract:

1. Sales price at book value of asset, with fixed annual rental adjusted to compensate for difference between book value and actual market value.
2. Sales price at more or less than

actual value, with compensating adjustment in fixed annual rental.

3. Fixed rental for long period of time, with option to extend lease at nominal rental.

4. Option or contract to repurchase property at termination of lease at a nominal amount, a fixed price, or at a price to be determined at lease expiration.

5. The repurchase price may be determined after considering:

- (a) Original sales price as against the actual value at original sales date.
- (b) The amount of fixed annual rental during the term of the lease as compared to the rental value of similar properties.
- (c) The amount by which the annual rental has amortized the lessor's original investment, after deducting a reasonable rate of return.
- (d) The actual value of the property at the expiration date of the lease, adjusted by any of the above factors.

The property involved may have belonged to the lessee for some time prior to the "sell and lease" agreement, and the lessee may have had a substantial equity in the property. However, in many cases, the property is newly acquired or newly constructed by, or for the account of the lessee, and title is transferred to the lessor immediately upon acquisition or completion of the property.

Purposes of Transaction

In general, the "sell and lease" procedure was designed as a form of long term financing of real property, plant and equipment. To the company which sold property which it had owned for some time, such arrangement afforded

GEORGE A. GREENBERG, C.P.A., has been a member of our Society since 1945. He was graduated from The College of the City of New York in 1938. At present he is on the staff of Klein, Hinds & Finke, C.P.A's. He has been a contributor to this magazine in the past.

the opportunity to obtain capital as a result of the sale of this property instead of by the creation of a debt. To the company which wanted to acquire new property, the transaction provided a means other than the conventional method of purchase usually accompanied by a long term mortgage commitment. In both situations, if we consider that the property was designed for the specific use of the lessee and that title to the property would probably revert to the lessee at the expiration of the lease, it is apparent that the lessee was in effect in the same position as if he were the owner of the property.

As a financing procedure, the seller can usually obtain the full appraised value of the property, whereas financial institutions are not usually willing to lend the full amount of the appraisal. To the insurance company, tax-exempt foundation, or other institutional lender, the inducement for such an agreement lies in the opportunity to make a reasonably safe investment which will yield an adequate return on the investment, and will return a good portion of the original capital investment within the term of the lease.

This method of long term financing received strong encouragement from pyramiding costs and the need for the creation of additional sources of capital. It is necessary for the independent accountant to acquaint himself with the reasons why such an arrangement was consummated in each case. His conclusion with respect to the reporting of such agreements may very well be partially based on the factors which necessitated such an agreement. Was the transaction entered into to provide funds for expanding sales, for additional merchandising operations, for new lines of business and for generally sound business purposes? Or was the arrangement made to bolster depleted working capital due to faulty operations, overinvestment in slow moving and hazardous inventories, or other generally unhealthy business conditions? In a "sale-lease" arrangement,

as in all other instances where additional capital becomes available to a company, it should be axiomatic for the independent accountant to acquaint himself with the reasons why such funds were needed, and the disposition of the funds. It is not generally the responsibility of the independent accountant to pass judgment on the soundness of a company's financial arrangements. However, we believe that in transactions of this nature, where problems arise in connection with the fixed and contingent burden on future years' operations, and where variations of the "sell and lease" contract may affect divergent interests, it is important that the independent accountant insist on getting all the facts.

Management has become very receptive to the principles of the "sell and lease" transactions, since this procedure seems to them to be an easy way to acquire funds without incurring indebtedness. In this connection, we quote from an article appearing in the September, 1948, issue of *The Balance Sheet*, published by the Controllers' Congress, entitled "Sale and Lease Financing."

"Not only does this make it possible for the corporation in the ordinary case to realize more than could be borrowed on the property, but it usually makes a better looking balance sheet. Furthermore, corporations are frequently restricted by provisions in their articles of mortgage indentures from incurring indebtedness in excess of specified amounts or are required to maintain certain ratios between indebtedness and other balance sheet items. Where this is true, there may be additional reasons for utilizing the sale and lease method of financing rather than incurring additional indebtedness."

Problems Involved

The independent accountant has a responsibility to report important and pertinent information. Furthermore, potential investors and lenders rely to a great extent on the reports of the independent accountant. To emphasize this point, we quote from the pamphlet "What Does An Auditor's Certificate Mean?", recently disseminated by the

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New York State Society of Certified Public Accountants:

"The independent audit fills a social need. It provides an impartial, expert financial interpreter as a kind of intermediary between borrower and lender, between management and stockholder, and between others who have financial relationships. Audits facilitate credit and investment. . . .

"The results are expressed in the auditor's report. It is a meaningful document, not issued lightly; it is worthy of careful study. It is designed to tell briefly and independently whether or not a company's financial statements are fairly presented in accordance with standards that are nationwide in scope and acceptance."

With these principles in mind, let us examine a hypothetical balance sheet of a company before and after a "sell and lease" transaction, and raise some problems which may be involved. Assume that in Balance Sheet "A" the company purchased the real property with funds acquired by a bond issue of \$1,000,000 to be amortized by twenty equal yearly payments of \$50,000. Assume that in Balance Sheet "B" the company acquired the property and simultaneously negotiated a "sell and lease" agreement, the selling price being identical with the acquisition price and the lease term being twenty years with an annual rental of \$55,000:

BALANCE SHEET "A"

Current Assets	\$1,000,000
Real property	1,000,000
<hr/>	
Total Assets	<u>\$2,000,000</u>
<hr/>	
Current liabilities (includes \$50,000 bonds maturing within one year) \$	50,000
Bonds (consists of 19 annual installments of \$50,000, maturing after one year)	950,000
Capital	500,000
<hr/>	
Total Liabilities and Capital	<u>\$2,000,000</u>

BALANCE SHEET "B"

Current Assets	\$1,000,000
<hr/>	
Current liabilities	\$ 500,000
Capital	500,000
<hr/>	
Total Liabilities and Capital	<u>\$1,000,000</u>

In the first case, the company has incurred a long term liability which re-

quires yearly amortization payments, and these facts are shown in the balance sheet. In the second case, the company has obligated itself to pay twenty annual rentals of \$55,000, yet there is no indication of this on the balance sheet. We have stated before that, in effect, the lessee was in the same position as if he were the owner of the property. Yet a potential lender could arrive at entirely different conclusions with respect to the wisdom of making a loan to the company, depending upon whether he was examining Balance Sheet "A" or Balance Sheet "B". Similarly, a prospective investor might be more cautious in purchasing the stock of the company if he saw Balance Sheet "A" rather than Balance Sheet "B". The former balance sheet may raise questions as to the worth of the real property, the ability of the company to meet its long term debt, the chances the company has of obtaining additional loans to take advantage of new business or seasonal business peaks, and similar considerations.

Stockholders may evince more than a passing interest in some of the provisions of a "sell and lease" contract. How is their equity affected if the assets were sold at less than actual market value in order to obtain favorable lease or rental terms? If inordinately large rentals are to be paid during the initial term of the lease, with a nominal rental upon renewal, how is their share of current earnings affected? Is there a contract to repurchase the property for a fixed amount at the termination of the lease? If so, what assurances are there that the repurchase price will compare favorably with the value of similar properties at that time? What other contingent liabilities may be incurred under certain conditions? What will happen if the company finds it cannot meet burdensome fixed rentals? These are questions which are very important to stockholders, and although the accountant cannot be expected to give specific answers to them in his reports, it is incumbent upon him to provide

Sell and Lease Transactions

sufficient information to enable the stockholders to answer these questions intelligently themselves.

"Sell and lease" agreements are sometimes not arms-length transactions. Therefore, complications may arise because of the very nature of the transaction, not the least of which are problems in connection with income taxes. This aspect is of such a broad nature, that it is worthy of a separate study. However, we mention some of the problems which may arise in this connection:

1. If the annual rental was predicated on the selling price, then:

(a) Property sold at a loss: Is the loss deductible in year of sale, or is the loss to be applied against the annual rental over the term of the lease?

(b) Property sold at a profit: Is the gain taxable in year of sale, or is the profit to be applied as a reduction of the annual rental over the term of the lease?

2. Option or contract to repurchase at termination of lease: Is the annual rental fully deductible as an expense, or is all or part of the rental applicable to the repurchase price?

3. Is the lease renewable at a nominal rental upon termination of the original term? If so, are the larger rentals paid during the original term of the lease deductible in the year paid, or will a portion of these rentals be deferred to the renewed period of the lease?

4. How will the Treasury Department view transactions which, in effect, allow the taxpayer to realize depreciation (in the form of rental charges) on his land as well as on his buildings?

Independent Accountant's Duties

In the past, it has not been deemed necessary in all cases to disclose information regarding leases where the terms were of the usual or ordinary character. However, we feel that "sell and lease" transactions are of a sufficiently different and important nature to warrant special treatment.

The independent accountant cannot afford to consider lightly, or omit reference in his report to agreements which were consummated to make a "better looking balance sheet," or which were utilized to by-pass restrictive terms of indentures. We are not intimating that the duty of the independent accountant is to predetermine and point out all eventualities or possible complications which may arise because of an agreement. However, he is ethically bound to disclose information regarding the existence of the "sell and lease" agreement, the date of its expiration, the amount of annual rentals, the existence of a repurchase agreement, and the extent of any other obligation assumed. This information is so important in the consideration of a financial statement, that the balance sheet should contain a reference which will direct the attention of the reader to the more detailed explanation in the accompanying "Notes to Financial Statements." In addition, it is not deemed sufficient to do this only in the year in which the transaction was consummated. The same treatment should be repeated throughout the term of the lease.

The hypothetical Balance Sheet "B", which was used in preceding paragraphs to illustrate a misleading picture of a company's financial condition, should read:

BALANCE SHEET "B"

Current Assets	\$1,000,000
Current Liabilities	\$ 500,000
Long term commitments (see note (1) of "Notes to Financial Statements")	
Capital	500,000
Total Liabilities and Capital	\$1,000,000

Note (1), or a footnote if notes did not accompany the balance sheet, would be (assuming some additional facts not given in the original example, for purposes of illustration):

"On September 15, 1948, the Company acquired land and buildings to be used as an additional warehouse at a cost of \$1,000,000. Simultaneously, the Company sold this

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property to the XYZ Insurance Company for \$1,000,000, and leased said property from the insurance company for twenty years from September 15, 1948, to September 15, 1968. The lease provides for an annual rental of \$55,000 and is renewable, at the option of the Company, for an additional term of twenty years at an annual rental of \$10,000. If renewed, the lease then requires the Company to repurchase the property at the end of the second twenty-year period for the sum of \$100,000."

The Securities and Exchange Commission has recognized the importance of general lease arrangements, and has provided for obtaining information with respect thereto. Regulation S-X provides that, in Schedule XVI, the amount of annual rent be disclosed, and Note Five calls for the aggregate amount of rentals on all real property leased to the company for terms expiring more than three years after the date of filing. Although there are no specific regulations with respect to "sell and lease" transactions, a request may be made for additional data as to the sales price, terms of lease, profit or loss, and details of any direct or contingent liability with respect to repurchasing the property. That the Securities and Exchange Commission considers the problem important is evident from a

deficiency letter which a company recently received from the S.E.C., a portion of which we quote:

"It is suggested that in future filings the footnote (in notes to financial statements) should be cross referenced to an appropriate caption on the related balance sheet such, for example, as 'Long-term lease commitments.'"

Since the "sell and lease" form of long term financing is a fairly new concept, the S.E.C. has not yet issued general rules covering the method of disclosing such agreements in financial statements, nor has the accounting profession in general formulated standardized procedures with respect thereto. This lack of uniformity must be, and we are sure will be, rectified in the near future. Until such standardized procedures become formulated and generally recognized, the independent accountant must base his decision with respect to "sell and lease" transactions upon the already generally accepted concept of his duties and responsibilities. If he does this, we are sure that he will come to the decision that these transactions must be fully disclosed in financial statements in such a manner as to be readily ascertained and understood by anyone who may use his report.

AN ADIRONDACK VIEW

Age Sixty-five. Its a funny world—including accounting and income taxes, as well as the spelling of February. Added exemptions of \$600 each came down from the skies in the Revenue Act of 1948. One is for being blind and the other for being 65 years old.

How blind one has to be to be blind we don't know, none of our clients has applied for this exemption. But, in some things, being over 50% of a certain class puts you in that class; for example, if your business is retail furniture and undertaking and 51% of the sales are mortuary and 49% furniture, then you are classified as being in the undertaking business. A percentage of 66⅔ is required to override a presidential veto; and 95% voting stock ownership is required for filing a consolidated return. Guess we better lay this proposition under the table.

But age 65 is a car of a different color. Up comes a case of a taxpayer born on January 1, 1884. There must be about 2,000 others in the U. S. according to our adding machine—we did our best to press the right keys. The t.p. said, "Too bad I was not born a few hours earlier". We said, "Wait a minute, we think your mother made the deadline all right—we mean, the birth-line".

The technicality is not how old you are but what age you have attained. The tax rule is that all persons born on January 1, are considered to have been born on the first second of the first minute of the first hour of that day. Quite an active second, wasn't it? Therefore, just as the last second of the last hour of the last day of 1948 ended our taxpayer had "attained the age of sixty-five". And he gets the added \$600 exemption and saves \$90 plus in taxes—which we, or he, or somebody else eventually has to pay.

Now do you know exactly how old you are?

LEONARD HOUGHTON, C.P.A.
Of the Adirondack "Chapter"

Presentation of Inventory and Material Commitments on the Balance Sheet

By JOSEPH SANDLER, C.P.A.

PURCHASE commitments made by manufacturers have become of increasing importance recently due to the efforts made by suppliers of raw materials to sell their output far in advance of actual delivery dates, and certainly long before the customer begins to process the material. These orders are being placed at a high level of prices and the amount of merchandise contracted for may be relatively high when compared with the purchaser's financial status. For this reason it becomes incumbent upon the accountant in the presentation of statements issued for credit purposes, to recognize the fact that losses may have to be sustained in periods of receding price levels. Certainly the credit man requires some information

to enable him to appraise the customer's ability to withstand the impact of a sudden recession in price levels.

In what form should this information be presented? It has been suggested that the accountant should show complete data with respect to purchase commitments on all statements submitted for credit purposes. I wish to point out some problems that would arise if this were to become a general or accepted practice:

1. The client may for various reasons be reluctant to disclose information that he regards as highly confidential and of possible value to his competitors.

2. While I concede that the amount of outstanding commitments as at statement date may be and should be readily determined, I believe that the information should be presented only when the accountant is of the opinion that it is of material significance in appraising the financial responsibility of the client. For example, a customer who has placed orders for less than his normal requirements and has a long history of consistently successful operations need not, in my opinion, disclose the amount of his purchase commitments. Reliance should be placed upon the accountant, in the exercise of his professional skill and in the light of his over-all knowledge of his client's affairs, to decide what unusual information should be set forth in statements issued for credit purposes.

3. If the accountant should submit data with respect to commitments, it should be incumbent upon the credit man to make further inquiry concerning the client's affairs so that

JOSEPH SANDLER, C.P.A., a partner in the firm of David Berdon & Co., C.P.A's., has been a member of the Society since 1920 and a member of the American Institute of Accountants since 1942. He is the author of several articles which have appeared in *The New York Certified Public Accountant*.

He is the present chairman of the Committee on Bankruptcy Procedure, vice-chairman of the Admissions Committee, a member of the Committee on Cooperation with Bankers, Committee on Cooperation with Credit Men and several other committees.

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he may interpret the information in the light of the specific circumstances surrounding each case. He must determine whether the amount of commitments outstanding represents a favorable or an unfavorable factor in the customer's financial affairs. He cannot make his determination from a mere statement of the dollar amount of commitments.

4. The amount of the outstanding commitments at statement date may be unusually low and future contracts of substantial nature may be placed shortly after such date or after the figures have been released. If this should be the case, the information as to commitments contained on the financial statements might be very misleading to the analyst.

5. If it is necessary to submit data with respect to material amounts of purchase commitments, it would then be proper also to include data with respect to matching future sales contracts or other factors, which may to a great extent offset the vulnerability of purchase commitments made at a high level of prices.

6. To submit the amount of purchase commitments on a statement without details may be further misleading because the commitments may have been placed some time before the statement date at prices below the prevailing level for comparable merchandise, and the client may feel that this represents a good asset instead of a possible liability. The client would probably object to giving details as to prices at which commitments were placed, on the ground that confidential information with respect to his individual operation would then be divulged.

7. Commitments made for mer-

chandise which is considered staple are in a different category from commitments for highly styled merchandise.

8. Lack of a free market may make it impossible for a manufacturer to make adequate commitments for materials which may be required to keep his plant operating. This would put him in an inferior position as compared with his competitors, despite the fact that the low volume of his future contracts (which information may appear on the statement) may seem to indicate that he is a more desirable credit risk.

9. The accountant, of course, must take cognizance of commitments made for merchandise at prices which are higher than those prevailing at statement date or at the date that the figures are released. Accounting Research Bulletin No. 29, issued by the American Institute of Accountants in July 1947, states the following:

"Accrued net losses on firm purchase commitments of goods for inventory, measured in the same way as are inventory losses, should be recognized in the accounts. The amounts thereof should, if material, be separately disclosed in the income statement."

10. Some financial statements have been issued which indicate that reserves for inventory losses are being provided for even in situations where prevailing prices are higher than those at which the inventory was evaluated or the prices at which commitments have been made. In fact, the American Institute of Accountants in Bulletin No. 31, issued in October, 1947, deals only with reserves provided "to absorb losses feared or anticipated with respect to inventories on hand, or in connection with future purchases."



Items on Financial Statements Which Should Be Scrutinized by the Credit Man

By STEPHEN CHAN, C.P.A.

IF I were a credit grantor, the first thing I would ascertain with respect to a financial statement is who submitted it and who prepared it. As the well-known Squibb slogan indicates, the main ingredient of the product is the ability and integrity of its maker. Your knowledge of your customers and their accountants should be broad enough to enable you to classify both, as to their *character* and *capacity*. These two "C's" of credit granting are as important as the third "C", *capital*, since capital may be lost more quickly than good character.

The second thing to look for, espe-

cially in style or seasonal industries, is the date of the statement. Mid-season figures differ drastically from end-of-season figures and the customer's true financial position cannot be intelligently interpreted without a knowledge of the industry's peaks and valleys. High inventories at the beginning of a season may be proper, but a large end-of-season inventory may be a forerunner of drastic markdowns.

Discussion of the date on the statement brings to mind a situation considered normal in some industries, namely the rendition for the purpose of obtaining credit of financial statements based upon a fiscal year which does not coincide with the fiscal year actually used for income tax purposes. The credit grantor in those industries, should, in my opinion, have a record of his customers' tax closing dates and should also obtain a financial statement at *that* date, in addition to any other reports he may receive throughout the year. In any case, the credit grantor should ascertain that adequate reserve is set up for Federal and State income taxes based upon the profit to the statement date.

In connection with taxes, it may be noted that many accounting firms indicate, as a balance sheet footnote, the year to which Federal income tax returns have been passed by the Bureau of Internal Revenue. This information is helpful to creditors in judging the contingent tax liability.

Consistency and conservatism have long been considered to be two of the keystones of proper financial reporting; this leads me to mention a situation which may require a clearer understanding of its consequences.

(Continued on page 116)

STEPHEN CHAN, C.P.A., has been a member of the Society since 1938, and also holds membership in the National Association of Cost Accountants and the American Institute of Accountants. He is presently serving as Chairman of the Committee on Administration of Accountants' Practice and is a member of the Committees on Cooperation with Credit Men, Cooperation with Bankers, Auditing Procedure, Publications, and Furtherance of the Objects of the Society. Mr. Chan has written a number of articles which have appeared in the *Journal of Accountancy*, the *Canadian Chartered Accountant*, and the *New York Certified Public Accountant*. He is a partner of the firm of Eisner & Lubin, C.P.A.'s.

This paper was presented at a Joint Dinner Conference of the cooperating committees of The New York Credit Men's Association and The New York State Society of Certified Public Accountants.

Recent Decisions on the Taxation of Partnerships

By ISIDOR SACK, C.P.A.

WE all know that if you have a valid partnership, recognized as such under the income tax law, the distributable income is taxed to the partners whether distributed or not, and that the partnership is not a taxpayer but rather a tax computing entity. That is about all we do know about partnerships. From then on we are in the area of doubt and conflict and confronted with decisions that point in every direction. The court decisions are full of discussion as to whether a partnership is a jural entity, and speculation about the nature of the partners' interests in the assets owned by the partnership. Many years ago, when Mr. Morgenthau was Secretary of the Treasury, he promised to introduce legislation which would clear up some of these doubts, or at least reduce their area, but evidently the task was more difficult than he anticipated, for nothing has been forthcoming almost since the first enactment of the income tax law. The need still persists.

In recent years there have been decisions on the following aspects of the partnership problem:

- (1) Should the organization in question be treated as a partnership or as some-

thing else, that is, a corporation or a trust?

- (2) What is the effect of transactions between partners on the formation or liquidation of a partnership? and
- (3) When is a family partnership treated as a partnership?

I do not aspire to teach you the law on this subject, as the Talmud puts it, "while standing on one leg," but maybe we can discuss some of the problems this evening and discover the trend of decisions even though we may not be able to clear all doubts.

I

Is the organization a partnership, a trust or an association

The Internal Revenue Code provides its own concept of a partnership (I.R.C., Sec. 3797 (a) (2)). The Code does not define the term "Partnership" except by stating that it includes in that term

"a syndicate, group, pool, joint venture or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not . . . a trust or . . . a corporation . . ."

The Code goes on to define the term "corporation" as including an association. (I.R.C. 3797 (a) (3)). This definition imposes the necessity of determining whether any given syndicate, pool or joint venture is to be treated as a partnership or as an association, in which latter case it is taxable as a corporation.

The Code does not define an "association" but the regulations do. (Sec. 3797-2)* The regulations are not helpful at all. The definition of partnerships (Sec. 3797-4) and limited partnerships (Sec. 3797-5) indicate that they may be treated as ordinary part-

ISIDOR SACK, C.P.A., and attorney, has been a member of our Society since 1922. He is also a member of the American Institute of Accountants.

Mr. Sack was formerly associate director of the New York State Income Tax Bureau and, also, Chairman of the Society's Committee on State Taxation. He is presently the Comptroller of a prominent New York banking firm.

* All references to Regulations, unless otherwise stated, are to Income Tax Regulations 111, Section 29.

nerships or as associations taxable as corporations depending upon the particular facts.

These regulations do state that if an organization is not interrupted by the death of a member or by a change in ownership of a participating interest and its management is centralized, such an organization is an association taxable as a corporation regardless of whether it has the form of a partnership or a limited partnership.

The court decisions are helpful but not determinative on this question. So many cases are decided on the facts that it is not possible to extract any clear principle as a sure guide in determining whether an organization is a partnership or an association for income tax purposes.

An organization does not have to be identical to a corporation but merely to resemble it to meet the judicial test of an association. If the resemblance points to features distinguishing it from a partnership, as well as from an ordinary trust, it will be treated as an association regardless of whether it is organized under a statute or with statutory privileges.

The leading case which lays down the criteria as to whether an enterprise is an association taxable as a corporation is that of *Morrissey v. Comm.*, 296 U.S. 344 (1935), which involved a trust created for the development of a tract of land. The following features were regarded as distinguishing an association taxable as a corporation from a true trust:

1. continuity of title;
2. centralized management;
3. continuity of the enterprise without interruption by the death of owners of beneficial interests;
4. transferability of interest without affecting the continuity of enterprise;
5. the introduction of a large number of participants;
6. limitation of personal liability; and
7. operating property for profit.

It is not necessary that all of these features be present for an organization to be classified as an association. If

enough of them are present so that it resembles a corporation more closely than a partnership or true trust, it will fall in that classification. The real test is whether the enterprise more nearly resembles in general form and mode of procedure a corporation than a partnership. Where an entity of this kind resembles a corporation in some respects and a partnership in others, the features of similarity should be compared and the marks of dissimilarity contrasted. The resemblances should be balanced. It should be determined by that test the one to which the enterprise is predominantly akin in the method, mode, and form of procedure in the conduct of its business. *Bert v. Helvering*, 92 F. (2d) 491 (C.C.A.-D.C., 1937).

In *Bloomfield Ranch v. Comm.*, 167 F. (2d) 586 (C.C.A.-9, 1948), the agreement between the members of an organization engaged in the disposal of real estate provided that it was binding on the heirs of each member, that the interests were transferable, that management was vested in one member (operator) and that the title could be taken in the name of that member or a corporation. The Court held that the organization constituted an association taxable as a corporation and not a partnership notwithstanding the lack of joint activity between the non-managing members (investors).

A syndicate formed to acquire the stock of a railroad company to simplify its capital structure was not regarded as having a business purpose similar to that of a corporation and was therefore recognized as a syndicate and not as an association. *Comm. v. United States & Foreign Securities Corporation*, 148 F. (2d) 743 (C.C.A. 3, 1945).

In *J. A. Riggs Tractor Co.*, 6 T.C. 889 (1946), the Tax Court decided that a joint venture was not an association because the interests were not transferable. As the Court said:

- "New partners could enter the firm only with the consent of all of the other partners. In view of the agency relationship existing between the partners, both by

virtue of the partnership agreement and the law of the state, that element is persuasive and tends to substantiate the claim of the partners that they intended to form an ordinary partnership for the conduct of its business."

Edmund R. Boots, T. C. Memo. Op., Docket #7493, June 25, 1947, dealt with a joint venture by the owners of patent rights for the exploitation, development and licensing of these patent rights. The uncertainty that exists in this field is clearly indicated by the fact that the Commissioner took two inconsistent positions as to the two years involved. In one year, where the distribution to the taxpayer was greater than his share of the earnings, the Commissioner contended that the venture was a corporation and the petitioner taxable on the distribution as a dividend. On the other hand, in the next year, when the net income was greater than the distribution the Commissioner determined that it was a partnership so as to tax him on the larger amount. As the Court said: "In these circumstances it can hardly be said that any particular sanctity attaches to the respondent's determination." On the entire record the Court concluded that this was a joint venture and more nearly resembled a partnership than a corporation.

In *Comm. v. Gerstle*, 95 F. (2d) 587 (C.C.A. 9, 1938), a syndicate was recognized as a partnership. Although the agreements gave the managers broad powers, the practice was to decide all questions of importance only after the views of all concerned had been obtained. There was no limitation of liability and the beneficial interests were not transferable, so the resemblance inclined toward the partnership status and not toward the corporation.

While it may not be possible to determine what factors will put a joint venture into the association classification the cases do seem to lean toward treating as an association any joint venture for business purposes where the interests of the participants are transferable and where the manage-

ment is centralized. These are the tests mentioned in the regulations so it is not surprising that the Courts put greater emphasis on these elements than on the others.

Mining Partnerships

In the exploration for minerals and the exploitation of oil lands it is necessary for co-owners of the mineral rights to join in the drilling and development operations. This creates a mining partnership which does not have the same attributes as a trading partnership. While a business partnership can only be created by express agreement of the parties, a mining partnership can be created without agreement and is inferred from the conduct of the parties. Mining partners have no express authority to bind each other nor to incur joint liabilities. A mining partner may sell his interest without the consent of all owners, or he may die and become insolvent, but no dissolution takes place by reason of such events. The mining partnership continues as to his heirs or transferees, who become mining partners by succession. *Glassmire Oil and Gas Leases and Royalties, Second Edition, Section 89.*

A very common form of organization for the development of oil lands is for all the co-owners of mineral interests to join in drilling operations and if oil is found, in the sale of oil or gas. So long as they are co-owners of the mineral interests and enter into this venture as such, and do not attempt by agreement to confer centralized authority to any one person but retain all the rights of co-owners, the joint venture will probably be able to maintain a tax status as a partnership. There are cases which would cast doubt on the proposition just stated, but in all of them there is some element in the arrangement between the parties which went beyond that of merely co-owners of mineral interests joining in the development of their property.

In *Wabash Oil and Gas Association v. Comm.*, 160 F. (2d) 658 (C.C.A. 1,

1947), cert. den., 331 U.S. 843 (1948), an organization for the purpose of operating an oil lease was held to be an association taxable as a corporation because the articles of agreement created conditions which made the enterprise resemble a corporation. There was centralized management, title in one person, transferability of interest and limitation of personal liability.

In *Helm & Smith Syndicate v. Comm.*, 136 F. (2d) 440 (C.C.A. 9, 1943), a group of individuals, who collectively purchased a tract of oil land, was held to be an association and not a partnership. In this case individuals purchasing land for the exploration of oil organized a trust. The trust agreement provided that it was to continue for 25 years, that the trustee had exclusive power to control the property, to develop and to sell it. Because of all these factors, the Court held that the trust was an association, taxable as a corporation. Upon dissolution of this trust another one was formed but the trustee there merely held the title as agent for the co-owners. During that period the Court held that there was no association.

In *W. F. Enright*, T. C. Memo. Op., Docket #6473, Dec. 19, 1945, co-owners of land joined to develop it. The Commissioner determined that the venture was an association, taxable as a corporation, but the Tax Court held to the contrary. The facts in this case indicate that the venture was the usual mining partnership, each participant remaining a co-owner of his interest in the lease and joining with the other co-owners only because it was necessary for all co-owners to join in an effort to discover the oil. The Court concluded that the enterprise was a partnership and not an association. In my opinion this case reflects the normal mining partnership arrangement. It is important to note that the ownership of the mineral interests must be retained by each co-owner. They may designate a common agent or a nominee but such agent should be a nominee only and re-

quired to act only on instructions from the co-owner. In the formation of mining partnerships it would be well to provide that all important decisions must be made by all the co-owners so as to avoid the imputation of centralized control and management.

Limited Partnerships

The Uniform Partnership Law provides for limited partnerships which have some of the characteristics of a corporation, such as limited liability for some partners, centralized management in the general partners and transferability of the interests of limited partners. They also have some of the characteristics of ordinary partnerships, such as unlimited liability for the general partners, and termination upon the death or withdrawal of a general partner. Because these elements are fixed by law I believe there is no solid ground for any contention that an entity recognized as a partnership under the Uniform Partnership Law should not also be recognized as a partnership under the income tax law. Sec. 3797-5 of the Regulations speaks equivocally on this subject but I doubt that any limited partnership formed and conducted in accordance with the uniform partnership law is in danger of being classified as a corporation. See, however, the cautionary comment in *Glensder Textile Co.*, 46 B.T.A. 176, at page 183, if the limited partnership should in fact be a sham.

In the theatrical field in this City a common practice is to form a limited partnership for the production of a play with the producer acting as a general partner and the "angels"—those that supply the money—as limited partners. It was rumored that the Commissioner considered making a test case to determine whether this type of organization in the theatrical field could be taxed as an association. No published ruling was made but the newspapers reported the Commissioner's conclusion that they will be recognized as partnerships.

II

Transactions Between Partners and the Firm

Organization of a Partnership

If a partner transfers an asset to the firm the basis to the firm is the contributing partner's basis (I.R.C., Sec. 113 (a) (13)), and the holding period dates from the date the contributing partner acquired it. (I.R.C., Sec. 117 (h) (2)). This may involve some discrepancies between the firm's books and the tax return with respect to both the income and its distribution.

For example: Assume a stock cost A \$10,000., but is valued at \$20,000. when A and B form a partnership, and A contributes this to the partnership for a credit of \$20,000. to his capital amount. If this stock is sold for \$20,000. the books will show no profit or loss, but the return will show a gain of \$10,000., which should be "distributable" to A.

If this stock is sold for more or less than \$20,000. the distribution is complicated but not difficult.

In order that this obviously fair result should not be questioned by the partners or by the Treasury, it would be wise to insert a provision in the partnership agreement that whenever a partner contributes an asset, all the gain realized on the sale of a contributed asset should first be "distributable" to the contributing partner up to the difference between the basis and the value on the date of contribution and only the additional gain should be distributable ratably among the partners.

An interesting case dealing with the basis of firm assets arose in *Robert E. Ford*, 6 T.C. 499 (1946). A novel contention was made by the Commissioner. A partner with a one-third interest in the firm sold her interest for cash to the other partners. The assets of the firm consisted of securities which had depreciated in value. When the securities were sold the Commissioner contended that the basis to the firm was not its original cost but two-thirds of

the original cost plus one-third of the fair market value when the retiring partner sold her interest. The Court decided against the Commissioner and held that the purchase of a one-third interest by the remaining partners furnished no ground for adjusting the cost basis to the partnership of assets it sold, saying:

"Since there was no dissolution or termination of the partnership in fact or by operation of law, we conclude that with respect to those securities sold by the partnership the original cost basis to the partnership of such securities is the proper cost basis for determining gain or loss to the partnership and the individual partners, petitioners herein."

Sec. 24 (b) (1) B of the Code disallows losses on sales between individuals and a corporation controlled by them. The applicability of this section to a sale by a partnership to a corporation controlled by the partners was an issue in *Commissioner v. Whitney et al.*, —F. (2d)—, (C.C.A. 2, 1948). This involved the incorporation of J. P. Morgan & Co. and the sale of the assets of the former partnership to the new corporation which was controlled by the partners. A large amount of securities was included in the sale which was effected at the market price and as was to be expected in dealing with the large amounts some of the securities showed a profit to the firm and others showed a loss.

The Commissioner challenged the deductibility of any loss on the ground that section 24 (b) (1) B of the Code cited forbids a deduction of any loss between an individual and a corporation whose stock is more than 50% owned by or for him. The Tax Court (8 T.C. 1019) held that this section did not apply to sales by a partnership but only to sales by individuals.

The Circuit Court had previously decided in the *Lehman case*, which we will discuss later on, that a partner has no individual ownership in any of the firm assets and this was relied upon by the taxpayers as supporting their contention that the partnership is an entity

owning and transferring property apart from its partners. The Court held, however, that the *Lehman* case dealt with a partner's sale of his interest in the firm and that the decision did not prevent the application of Sec. 24 (b) (1) B to disallow the deduction of a loss on a sale from a partnership to a corporation controlled by the partners.

With respect to the conflicting theories as to the nature of a partnership and on the basic issue as to the nature of a partner's interest in firm property the distinction between this case and the *Lehman* case is very fine. I think the decision rests on stronger grounds insofar as it decides that Section 24 (b) (1) B applies to a situation of this kind and the full discussion of the legislative history of that section and its purpose can justify the decision on that ground alone, although the Tax Court reached a different conclusion after an equally full consideration of the legislative history of this section.

Retirement of a Partner: When a partner dies or retires and thereafter receives some part of the income of the firm for a limited period the tax consequences depend very largely on the provisions of the partnership agreement. A provision in the agreement that a sum be paid to him for good will or for his interest in the assets or capital of the firm precludes the deduction of the payment by the continuing firm even though it is paid out of earnings. If, however, a retiring partner participates in earnings for a specified term after his retirement the continuing partners would not be taxable on the income so distributed.

The question often arises on the return of a continuing or succeeding partnership when it takes as a deduction the amount of income paid to a retired partner or the estate of a deceased one. The Commissioner has frequently attempted to disallow the deduction on the ground that the succeeding partners are taxable on all the income of the firm and any payment made to a prior partner or his estate

is a payment for some asset, be it good will, capital or otherwise, and is not deductible.

In *Richard P. Hollowell*, 39 B.T.A. 50, the agreement provided that upon the death of a partner the partnership shall continue for a period with the estate as a partner. The Court held that the estate's share of the income was not income of the surviving partners.

One of the leading cases on this point is *Ernest M. Bull v. U. S.*, 295 U. S. 247 (1935), in which the Supreme Court held that where a partnership agreement provided that in the event of the death of a partner the survivors should continue the business for one year thereafter, and that the estate was to share profits and losses, the amounts paid to the estate as profits earned after the decedent's death were income to the estate and not to the surviving partners.

The Court stated:

"Where the effect of the contract is that the deceased partner's estate shall leave his interest in the business and the surviving partners shall acquire it by payments to the estate, the transaction is a sale, and payments made to the estate are for the account of the survivors. It results that the surviving partners are taxable upon firm profits and the estate is not. Here . . . the survivors have purchased nothing belonging to the decedent who had made no investment in the business and owned no tangible property connected with it. The portion of the profits paid his estate was, therefore, income and not corpus; and this is so whether we consider the executor a member of the old firm for the remainder of the year, or hold that the estate became a partner in a new association formed upon the decedent's demise . . ."

Many cases have turned upon the provisions of the partnership agreement. For example, in the *Estate of George R. Nutter*, 46 B.T.A. 35, aff'd. 131 Fed. (2d) 165 (C.C.A.-1, 1942), although the case dealt with the estate tax of a deceased member of a law partnership the opinions of the Board and the Circuit Court deal with this question. In this case the partnership agreement provided that the estate of a

deceased partner shall continue to receive the same percentage of the net profits of the firm for 18 months after death, and that

"this shall be in full of the retiring or deceased member's interest in the capital, the assets, the receivables, the possibilities and good will of the firm."

Because the language of the agreement was couched in terms of the purchase of a deceased partner's interest in assets, it was held that the surviving partners are taxable on the firm's profits and the estate is not.

This decision was distinguished and a contrary result reached where the partnership agreement contained no such provision, in the case of *Charles F. Coates*, 7 T.C. 125 (1946), which dealt with an accounting partnership where the estate of a deceased partner was entitled to a share of the partnership earnings for five years after date of death. The case dealt with the right of the surviving partners to deduct the amount paid to a deceased partner. The Commissioner made his usual argument that the estates were not partners and were not entitled to participate in the partnership earnings; that the surviving partners earned the income by their personal services and are therefore taxable on it, and that the payments of income after the death of the deceased partners constituted consideration for the purchase by the survivors of the decedent's share in the partnership. The Court held, however, that the income earned after the death of deceased partners, and paid to their estates pursuant to the partnership agreement as the share of the earnings properly allocable to the decedent is not taxable to the surviving partners.

A similar result was reached in *Estate of Frederick C. Bellinger*, T.C. Memo. Op., Docket #4562 (Feb. 14, 1946), which involved a law partnership, as did *John C. Madden et al*, T.C. Memo. Op., Docket #5075 (July 2, 1946), and in both cases the Court decided that the agreement gave the estate of a deceased partner only a share of earnings and held that the surviving partners were not taxable on

such income; in both cases distinguishing the *Nutter* case on the ground that the agreement there specifically dealt with the acquisition of good will and tangible assets.

Raymond S. Wilkins, 7 T.C. 519 (1946), also involved a law partnership but the provision there was that the estate of a deceased partner should be paid an amount equal to one-fourth of the amounts distributed to the deceased during the two years preceding his death. The Court held that this was an agreement to pay a sum certain, payable at all events, having no aspects of a distributive share of partnership income. It distinguished this fact from those in the other cases cited and held that the surviving partners are taxable on their share of the income without any deduction for the payment to the estate of the deceased partner.

On appeal, the taxpayer contended that the surviving partners had no beneficial interest whatever in the payments made to the deceased partner's estate and that these payments should be regarded as a distribution of partnership income not taxable to the surviving partners or allowed as a deductible expense of the partnership. The Court said: "We see strength in the taxpayer's proposition" but felt that under the *Dobson* case the decision of the Tax Court was beyond its power to review and therefore affirmed the decision of the Tax Court. 161 Fed. (2d) 830 (C.C.A.-1, 1947).

Distribution of Assets: When assets of the firm are distributed to a partner the basis to the partner is determined by I.R.C., 113 (a) (13), which provides that: "If the property was distributed in kind by a partnership to any partner, the basis of such property in the hands of the partner shall be such part of the basis in his hands of his partnership interest as is properly allocable to such property".

In *G.C.M. 20251*, 1938-2 C.B. 169, the general counsel interprets the phrase "properly allocable" as referring to an amount determined by reference to the value of the assets at the

time of distribution. This G.C.M. also discusses the holding period of assets received by partners from the firm and concludes that the holding period begins at the time of the acquisition of the asset by the firm. This ruling is based on the Commissioner's view that partners are vested even before distribution with an interest in specific firm property as co-owners by a tenancy in co-partnership.

The effect of this provision is that all of the assets of a partnership must be valued. You must then allocate to the asset distributed to a partner that portion of his basis for his partnership interest which the distributed asset bears to his interest in all the firm assets. So, if an asset is distributed to several partners each may well come out with a different basis.

This is a very complicated rule and leads to queer results but I know of no case where the rule has been questioned.

Sale of an interest in a partnership: On the question of the tax results of a sale by a partner of a partnership interest, the Courts have indulged in a considerable amount of theorising about the nature of a partnership interest, whether a partnership is a separate entity or whether each partner is the owner of an undivided interest in each partnership asset. There is a conflict in the basic theory of a partnership and the cases are not all consistent on that point.

It is well settled that a partner's interest in the firm is a capital asset and that a sale results in a capital gain or loss.

Comm. v. Shapiro, 125 F. (2d) 532 (C.C.A. 6-1942);

Kessler v. United States, 124 F. (2d) 152 (C.C.A. 3-1941);

Lehman, 7 T. C. 1088.

The speculation indulged in about the nature of a partnership interest has led to conflicting decisions and views in determining what a partner sells when he sells his partnership interest and what is his holding period. The Commissioner has argued without much success that a partnership is an associa-

tion of individuals holding property in a "form of co-ownership."

In the case of the *City Bank Farmers Trust Co. et al v. U. S.*, 47 Fed. Supp. 98, Court of Claims, 1942, the Court of Claims adopted the Commissioner's theory. In this case, a partner sold his interest in the partnership business and the question presented was whether the holding period for the purpose of applying the percentage rate on capital gains is to be measured from the date when the partner acquired his partnership interest or from the date when the partnership acquired the specific assets, which the partnership owned when the partner sold his interest in the firm.

The Court held that a partnership is to be considered for the purpose of measuring the holding period as "an association of individuals who, for tax purposes, are vested with an interest in the specific partnership property." However, this case has not been followed by other courts but on the other hand has been specifically disaffirmed in several cases.

Thornley v. Commissioner, 147 F. (2d) 416 (C.C.A. 3, 1945);

Lehman, 7 T. C. 1088.

The most recent case involving this point is that of the *Commissioner v. Allan S. Lehman*, 165 F. (2d) 383 (C.C.A.-2, 1947), where the Court held that the holding period to be considered in determining a tax to a partner upon his profit on the sale of a partnership interest is to be measured from the date on which he acquired the partnership interest and not from the date the firm acquired the assets held on the date of sale, and this must now be regarded as a settled law on this subject.

The Court in its opinion held that a partner had no specific title in any asset owned by the partnership, but that the individual partner's beneficial interest as a legal joint owner was limited to seeing that the firm's assets should be devoted to the firm's business and he should share in any profits they produced and in the surplus upon winding up.

Another interesting point involved in the *Lehman* case was whether the death of a partner terminated the partnership and made the succeeding partnership an entirely new one. The Uniform Partnership Law provides that the death of a partner dissolves a partnership. Although the Tax Court, 7 T.C. 1088, discussed this point differently than did the Circuit Court both seemed to be agreed that where a partnership agreement provides that the business shall continue after the death or withdrawal of a partner, that realistically speaking the only change that takes place is that the remaining partners have acquired a greater interest in the profits and surplus when final liquidation occurs.

The Tax Court specifically states that although by general rule of law, death or withdrawal of a partner dissolves a partnership, it is competent for the parties to provide otherwise. The provisions of a partnership agreement therefore have an important bearing on the tax results flowing from the death or withdrawal of a partner.

III

Family Partnerships

The effort of taxpayers to divide income among members of their families is an old one. A common device is to take in members of the family as partners, either without capital or with capital donated by the taxpayer; sometimes the members of a family perform services and in others their services are merely nominal; occasionally a trust for a member of the family is made a partner, and so on with many ingenious ramifications.

At one time, in *Glensder Textile Co.*, 46 B.T.A. 176, the Commissioner attempted to reach these as associations taxable as corporations but in recent years he has attacked family partnerships by asserting that the income of the partnership was taxable entirely to the principal operator as his income.

The Supreme Court, in two companion cases, *Commissioner v. Tower*, 327 U. S. 280, and *Lusthaus v. Commissioner*, 327 U. S. 293, both decided on

February 25, 1946, disposed of much of the confusion as to whether family partnerships would be recognized for tax purposes. In both these cases it held that although a valid partnership existed under the state law, there was no true partnership between the taxpayer and his wife for tax purposes because no genuine union for partnership business purposes was ever intended, no capital not previously available for use in the business was brought into the business, no change was made in the actualities of the parties' relation to the income, and the effect of the partnership was a mere paper reallocation of income among the family members. The court did not condemn all family partnerships as not entitled to recognition under the income tax law but only those where under the facts the partnership relation lacked reality.

In view of the persistent and continuing attack on all family partnerships by the Commissioner it is important to bear in mind the following statement of the Supreme Court:

"There can be no question that a wife and husband may, under certain circumstances, become partners for tax, as for other purposes. If she either invests capital originating with her or substantially contributes to the control and management of the business, or otherwise performs vital additional services, or does all of these things, she may be a partner as contemplated by 26 U.S.C. (I.R.C.) Secs. 181, 192.***"

The cases that have been reported since the *Towers & Lusthaus* cases are very numerous. New decisions are coming down every week and it seems to be one of the most litigated subjects before the Tax Court. It is not worthwhile to discuss many of them, as the underlying principle is becoming clear that family partnerships which have reality in that the partners contribute additional capital or perform vital services will be recognized for income tax purposes, whereas those that do not have these characteristics will not be.

Mertens Law of Federal Taxation, 1948 Supp., Sec. 35.09, summarizes the development that has occurred since these decisions very clearly, as follows:

"Where the interest of a wife or child in a purported partnership arrangement originates solely as a gift from the husband or father in the capital assets of his business enterprise and thereafter the donee of such interest does not contribute substantially to the management of the business and renders no vital services thereto, this type of arrangement with respect to either the wife, or the child, or the wife and child, is not recognized for Federal income tax purposes."

In *W. O. Culbertson, Sr. v. Comm.*, 168 F. (2d) 979 (C.C.A. 5, 1948), the Court found a valid partnership between Mr. Culbertson and his sons notwithstanding that the capital contributed by the sons was derived by them by way of gifts from the father. The Court made the following significant comment on the thinking which has been indulged in since the *Lusthaus* and *Tower* cases:

"It seems that out of the cases of *Lusthaus v. Comm.*, supra and *Comm. v. Tower*, supra . . . a concept has been born and is carefully nurtured by the tax collecting agencies that no partnership is valid—income-tax-wise—between members of a family unless the members of the family coming into the partnership actually contribute money or had actually, theretofore, rendered services. Neither statute, common sense, nor impelling precedent requires the holding that a partner must contribute capital or render services to the partnership prior to the time that he is taken into it.

Neither the Constitution, the statutes, nor public policy requires that partnerships between fathers and sons be outlawed or discouraged. The desire of a father in any age or clime, with a business that he cherishes and a son that he loves, to have such son with him in his business and to carry it on when he no longer can was not rendered an anathema by the *Lusthaus* and *Tower* cases, and aberrations from the salutary rules announced in those cases should not now do so."

Most of the cases follow a similar pattern, but that of *Edward G. Wetzel*, T.C. Memo. Op., Docket #10293, April 27, 1947, has an interesting variation. Here a wife owned a business but her husband managed it. The Commissioner not only recognized him as entitled to a share in the earnings of the business but determined that all of the earnings were taxable to him, but the

Court held that the Commissioner was wrong in taxing to the husband more than one-third of the profits which the partnership agreement entitled him to.

Where the partnership interest of a wife, son and daughter came not from the taxpayer but from a former partner of the taxpayer the principles of the *Lusthaus* and *Tower* cases are not applicable. For instance, in *Durwood v. Comm.*, 159 F. (2d) 400 (C.C.A. 8, 1947), the taxpayer's wife, son and daughter acquired their interests in the business from former partners, the taxpayer's brothers. As they had capital interests in the business, not coming from the husband, the partnership was held to be valid and the taxpayer was not taxable on all of the profits of the business.

Where a wife and son performed vital services, although the capital contributions were gifts from the taxpayer, the partnership was recognized as meeting the test laid down in the leading cases. *Greenwald v. Comm.*, T.C. Memo. Op., Docket #1481, May 28, 1948.

A variation from the main line of cases is found in *Geo. W. Ruppel v. Kuhl*, decided in U. S. District Court, Eastern District of Wisconsin, May 17, 1948, where although the taxpayer's wife was not a member of the partnership, in which the taxpayer had a one-third interest, he and his wife had a sub-partnership with respect to that one-third interest. This sub-partnership was recognized as valid because the wife provided the capital required by the husband to acquire his one-third interest.

Since the enactment of the Revenue Act of 1948, with its provision for optional joint returns by husband and wife, the recognition or non-recognition of partnerships between a husband and wife is of no great importance. The problem is now confined to partnerships between father and children or a taxpayer with other members of his family.

In several cases, the Tax Court, although recognizing that the partner-

ship was valid, attempted to reallocate the partnership profits in a manner not provided by the agreement so as to attribute some part of the profits to those partners who performed services and to apportion only the remaining profits to the non-working but capital contributing partners. The Circuit Courts have not looked kindly on this at all.

The Sixth Circuit Court of Appeals reversed the Tax Court in two cases, *Woosley v. Commissioner*, 168 Fed. (2d) 330, and *Canfield v. Commissioner* 162 Fed. (2d) 907, holding that there is no justification for ignoring

the express provisions concerning the division of profits written into a bona fide agreement between husband and wife.

In a very recent case the Eighth Circuit adopted the same principle, again reversing the Tax Court, and held that where a bona fide partnership existed the division of income pursuant to the partnership agreement cannot be arbitrarily ignored. The attempt by the Tax Court to reallocate income by assigning only a portion of the income in accordance with the capital contributions was overruled. *Hartz v. Commissioner*,—F. (2d)—, (C.C.A. 8, 1948).

Items on Financial Statements Which Should Be Scrutinized by the Credit Man

(Continued from page 105)

There is general agreement that, especially in a seasonal or style industry, the inventory should be conservatively stated, and should be priced at less than cost when necessary to reflect market declines, slow moving or obsolete items. However, many business men have, in these high profit years, been extremely conservative in valuing their inventories. This pleases credit grantors on the ground that it results in a conservative statement and thus in a conservative line of credit, but your attention should be directed to the following important points:

(a) An arbitrary reduction of one year's inventory throws unearned profit into the following year, thus distorting both years' results, unless exactly the same amount is taken out of the subsequent period's closing inventory.

(b) Indiscriminate and inconsistent inventory reductions are, of course, not permissible under the income tax laws. Concerns indulging in these practices are therefore subject to the contingency of a possible tax assessment upon examination by the Treasury Department in a future year.

(c) In case of a fire loss, it may be difficult to prove and collect the

full loss, because of the arbitrarily reduced book inventory figures and the conflict with tax return figures.

(d) Last, and most important, is the fact that in bad times the business man does not value his inventory items as conservatively as he does in good times; and once the consistency of the financial statements is destroyed, there is no sound basis for statement analysis, comparison of progress and operating ratios, or budget comparisons.

The credit grantor should ascertain that *interim*, or so-called "trial balance", figures presented for credit, include a proportionate accrual of officers' salaries and year-end bonuses even though not yet drawn, as well as accrual of the full income and franchise tax payable on the indicated profit to date. Especially in the smaller business, these liabilities may be large in relation to capital and current assets.

The credit man should also inquire whether adequate provision has been made for discounts and allowances to be granted on the accounts receivable reflected on the balance sheet; and whether the bad debt reserve is adequate based upon a recent ageing or detailed review of the accounts, giving proper consideration to collections in the month following the statement date.

The Old Order Changeth

By THOMAS W. BYRNES, C.P.A.

SINCE the early 1900's the vocation of public accountancy has attracted young persons seeking a professional activity not overcrowded. Until comparatively recent times practitioners have not been very particular in examining the educational backgrounds and the aptitudes of applicants for staff positions. However, as the demands upon the profession grew, greater knowledge was required to cope with increased responsibilities, and selectivity became necessary. To aid in accomplishing this purpose, the American Institute of Accountants has prepared aptitude tests which have been adopted by many firms of public accountants, large corporations, and collegiate schools of business.

The new requirements while praiseworthy and bound ultimately to result in credit to the profession may, by some people, be considered as selfish and redounding to the benefit of employing accountants only. This leads to the question: Has the public accounting profession kept pace with industry, to which it is so closely allied, in the matter of providing for the welfare of staff members?

The accelerated tempo of life in a changing world, and particularly in these United States, has resulted in such a demand for youth in industry, and in the professions serving industry, that the position of the unemployed

mature person has become precarious. One has only to read the advertisements for "Help Wanted" to observe the trend of the times. Youth and its vocational advisers are noticing this and are carefully weighing the future when prospective employment is under consideration.

The trend of the times extends also to public accounting. A prominent practitioner told the present writer some time ago that his firm will not engage anyone who is more than 30 years of age. Also, a recent instance was noted when a well-known firm of public accountants released a number of men aged 40 or over, some of whom had been in its employ for many years, replacing them with college graduates in their twenties. This sort of thing gets around and will, unless something counteracting is done, place the profession in the undesirable light of using its assistants in their prime and casting them adrift at a time when it will be difficult for them to obtain other lucrative employment.

Those who contemplate entrance into the field of public accounting, presently and in the future, must be assured of something beyond immediate positions and the slim possibility of a future partnership interest. And it is here that the profession can take a leaf out of industry's book and establish pension and other welfare plans. Because public accounting is carried on by partnerships and sole practitioners, the matter of pension plans would have to be developed, it would seem, on a profession-wide basis. Thus, a staff member moving from one employing accountant to another would be covered at all times, somewhat in the manner that teachers are protected. A committee composed of members of the leading accounting societies could endeavor to interest one of the long established in-

(Continued on page 126)

THOMAS W. BYRNES, C.P.A., has been a member of the Society since 1911, and is a Certified Public Accountant of New York and New Jersey. He is also a member of the American Institute of Accountants. He was formerly as Associate Professor of Accounting at Columbia University.

New York State Tax Clinic

Conducted by BENJAMIN HARROW, C.P.A.

Doing Business in New York

A foreign corporation is subject to the franchise tax if it does business in New York. This is so even if the foreign corporation has failed to qualify formally in New York. Not all activities of a foreign corporation in New York would subject the corporation to the tax even though such activities come within the scope of the doing of business. Some of these activities are viewed as a part of interstate commerce which New York may not unduly burden. For example, if the only activity in New York of a foreign corporation is the solicitation of orders through traveling salesmen, or even the maintenance of a sales office, the corporation is not subject to the franchise tax. Of course the orders for merchandise must be accepted outside the state at the home office and the merchandise must be shipped from a factory outside the state. If the merchandise were shipped from a stock of goods regularly main-

tained in New York, the foreign corporation is deemed to be doing a taxable business in New York.

Suppose the only activity of a foreign corporation in New York is the maintenance of a purchasing office. Does that activity constitute the doing of taxable business in New York? We have previously touched on this problem. We mention it again because of a recent New York Supreme Court decision¹ on another aspect of the problem of doing business. How much business must a foreign corporation do in this state to be subject to service of process? The fact that such a corporation may be served in a legal action in New York, because it is doing business here, does not mean that it is therefore also subject to tax because it is engaged in some activity which may subject it to the service of process.

In this case, the foreign corporation maintained a purchasing office and staff in New York. It also maintained a bank account. This latter fact is not given consideration in determining whether the foreign corporation is doing a taxable business. The corporation made extensive purchases in New York. The New York office was listed in the telephone directory and it requested duplicate invoices for purchases mailed to its New York office. The court held that the corporation was subject to process in New York. Whether it is also subject to tax is in doubt. If the purchasing activities are merely a part of the interstate activities in the same sense that selling activities, though localized to some degree within the state, are really a part of the interstate activities, then the corporation is not doing taxable business within the state. In the case of selling activities,

BENJAMIN HARROW, C.P.A., has been a member of our Society since 1928. He is a Professor of Law at St. John's University.

Mr. Harrow has been a member of the American Institute of Accountants since 1922 and is a member of the New York Bar. He is presently serving on the Society's Committees on Federal Taxation, State Taxation, Cooperation with the State Education Department and Its Agencies, and Cooperation with the Bar.

Mr. Harrow is engaged in practice as a certified public accountant and attorney in his own office in New York City.

¹ *Mitchel Schneider Co. Inc. v. Gamble Shapero, Inc.*, N.Y.L.J., 10/6/48, p. 698.

the regulations emphasize the place of acceptance of the order and the situs of the merchandise when shipped. In the case of purchasing activities, the shipment of the merchandise to New York would probably make the activity taxable in New York, as would the localization of the purchase contract in New York. The regulations are silent on the tax effect of purchasing activities. Each case would probably be decided by the Tax Commission on its own facts.

The Property Factor in the Business Allocation Percentage

If a corporation has a regular place of business outside New York it may allocate its income on the basis of three factors, one of which is the ratio of real and tangible personal property in New York to the total real and personal property within and without New York. The Regulation (Art. 412) says that only property owned by the taxpayer is considered in determining this percentage. It is thus possible to change the income allocation by changing the control of the property, for example, from ownership to some leasehold arrangement.

President Bates of the State Tax Commission calls attention to this situation in a speech delivered by him in October before a meeting of the National Tax Association. Said the Commissioner,

"Property rented by a taxpayer and used by it in its business is as much a material income producing factor as property owned by the taxpayer and used in its business."

He suggests that both types of property be given the same weight in the property factor. We may expect the 1949 legislature to adopt some means of bringing rented property within the property factor.

President Bates also called attention to a distortion that results where the property of a taxpayer consists only of office furniture and fixtures. The Tax Commission has issued a ruling that in such a situation the taxpayer may apply to the Commission for elimination

of the property factor and the substitution of business expenses other than salaries and wages as a third factor.

Receipts Factor in the Business Allocation Percentage

Generally receipts are allocated to New York if they result from sales of goods shipped from New York or if the order for the goods is received or accepted in New York and the goods are not located at any permanent or continuous place of business maintained by the taxpayer outside New York at the time of the receipt of the order or at the time when the goods are appropriated to the order. If the goods are shipped from a permanent or continuous place of business outside New York the receipt is allocable outside New York.

President Bates said in his speech that there had been some difficulty in administering these provisions where the orders were received and accepted outside New York by an employee of the taxpayer attached to the New York office of the corporation or by an independent contractor or warehouseman where the goods were shipped from a public warehouse outside New York. A 1948 amendment to the law made it clear that such sales are allocable to New York.

Payroll Factor in the Business Allocation Percentage

In this factor only compensation paid to employees other than general executive officers enters into the computation. When new Article 9A was enacted in 1944, compensation to general executive officers was excluded from this computation because of the difficulty in determining geographically where the compensation was earned.

President Bates in his speech said that the question of excluding such compensation merits reexamination. He says that many general executive officers act as salesmen in particular localities or render other services that can be localized. Inclusion of all or

part of the compensation in such cases would be warranted. President Bates said this question is now being studied with a view toward possible amendment of the statute. Even without any amendment of the statute a taxpayer may now present facts to show that an inequity results where the compensation of an employee is allocated to New York because he is attached to a New York office whereas a substantial portion of his services is performed outside New York. In such a case the Commission may in its discretion permit the payroll factor to be computed on the basis of the services actually rendered within and without the State.

Allocation by a Separate Accounting Method

Such a procedure is not permitted although it is acceptable under the unincorporated business tax law. President Bates in his speech gives as a reason for this the difficulty in attempting to apportion such items as general overhead expense and advertising. Accountants would not find this difficulty an insuperable obstacle. President Bates also said that many states which formerly allowed separate accounting are no longer permitting it. He called attention to the fact that the Commission has considerable discretionary power to adjust the allocation factors but that this power has been exercised in rare cases. It seems to be the policy of our State Tax Commission to amend the law rather than to correct defects through administrative expedencies.

Real Estate Corporations— 2% Tax on Dividends

In addition to the tax of one-fourth of a mill on the full value of its gross assets, (Sec. 182.1) a real estate corporation is subject to an additional tax of two percent on all dividends paid during the year. For the purpose of this tax,

"ninety percent of interest paid on debenture bonds or certificates of indebtedness

or certificates of beneficial interest, or promissory notes or other indebtedness to any stockholder or shareholder, or members of his immediate family, owning in the aggregate in excess of five percent of the issued capital stock of the corporation, the proceeds of which are used to acquire assets, shall *** be taxed as dividends, ***."

Prentice-Hall in its New York Tax Report Bulletin No. 11 of November 29, 1948, makes an interesting comment on this provision (pp. 27,009). Does the 2% tax apply to interest on debenture bonds no matter who receives the interest, or does it apply only to stockholders and members of their immediate families owning more than five percent of the issued stock? In interpreting this provision for or against the tax, the comma after the word "shareholder" is significantly emphasized. If the words, "members of his immediate family, etc." apply only to promissory notes or other indebtedness (except debenture bonds, certificates of indebtedness, or certificates of beneficial interest) then ninety percent of all interest paid to all holders of debenture bonds is taxed as dividends. If those words apply to debenture bonds as well as promissory notes then such interest paid to holders of such bonds who are not members of the immediate family of stockholders is not to be taxed as dividends.

This question is of interest even though the courts have already considered the problem in *Geroso Paladino Holding Corp. v. Graves*.² In that case the court held that the interest is taxable as a dividend no matter who holds the bonds. But the bonds in that case were actually held by the wives of the shareholders. It is argued, however, that the purpose of the 1947 amendment was clearly intended to apply only to stockholders and the immediate members of their families who employ the device of unsecured indebtedness to capitalize the acquisition of assets. To consider interest on unsecured indebtedness in the hands of the public

² 264 N.Y. 442 (1934).

as a dividend would seem to be stretching the meaning of the term dividend far beyond the accepted meaning of the term.

It should be noted that bonds secured by the real estate or the rents therefrom do not come within this provision of the law even though the bonds are held by stockholders. This question came before the Court in *Mercantile Properties, Inc. v. State Tax Commission*³ which held that interest paid on secured indebtedness is not taxable as a dividend.

Prentice-Hall points out that under the Shackle Act there have been reorganizations where secured mortgage bonds have been converted into unsecured debenture bonds, many of them now publicly held. Interest on the original secured bonds would not have been taxed. Query: Would the interest on the unsecured bonds substituted for the original secured bonds now be subject to tax?

More on the 2% Tax on Dividends

The unorthodox treatment of the concept of dividends is further highlighted in a recent opinion by Deputy Commissioner Mortimer M. Kassell.⁴ He was asked to give his opinion on whether accrued interest on promissory notes paid by a liquidating real estate corporation to a stockholder was subject to the 2% tax. At the date of liquidation the corporation had a deficit. The corporation was organized in 1935 and had borrowed over \$500,000 on interest-bearing notes. The money was used to acquire real estate. For a few years interest was paid annually on the notes. For the years 1940 to 1944, inclusive, interest was accrued and net losses were reflected in an amount less than the interest accrued. A portion of the earnings was therefore available for interest payments. In 1945, the property was sold at a loss of \$600,000 resulting in a large capital

deficit. Upon liquidation the notes were paid together with accrued interest of \$155,959.87. The question was the extent to which the interest payment was subject to the 2% tax on dividends.

The opinion is an excellent summary of the legislative history of section 182. As Commissioner Kassell points out, the fundamental purpose of the several amendments to this section has been "to keep pace with the various and oftentimes devious processes evolved for accomplishing earnings distributions on a tax-free basis". Taxable distributions are limited to those derived from earnings, profits, or asset appreciation. Those taxpayers who dissolve their corporations to circumvent the *Court Holding Co.* decision often overlook the 2% tax they walk into on the appreciation of those assets which they receive in distribution for their stock. A distribution of capital is not considered a dividend. This would include a distribution covering paid-in capital or paid-in surplus.

Commissioner Kassell states that the 1930 amendments to the law were designed to thwart the practice of capitalizing a real estate company at a low amount and obtaining funds through unsecured indebtedness on which unlimited tax-free distributions could be made under the guise of interest, which distributions would be taxable if distributed as dividends. What the law did was to treat the holders of such indebtedness as essentially in the position of preferred stockholders and the interest distributions virtually as dividends.

The provisions of subd. 2 of section 182 were added in 1930 to prevent the accumulation of earnings and then distributing them in liquidation without payment of the 2% tax on dividends. Under this provision upon liquidation the 2% tax applied to "earnings not heretofore used as a basis of any additional franchise tax". A 1938 amend-

³ 278 N.Y. 325 (1938).

⁴ September 14, 1948.

ment changed this to apply to distributions not only from earnings but from whatever source.

It should be noted that it is possible under the Internal Revenue Code to subject an accumulated surplus to the capital gains tax instead of the normal and surtax on ordinary income through this device of liquidating the corporation.

Commissioner Kassell concludes that the accrued interest on the promissory notes is taxable to the extent that the corporation earned the amounts distributed. Says the Commissioner,

"The time or manner in which the earnings were realized and the time or manner in which the distributions were made are immaterial considerations. The status of the corporate finances at the time of distributions is likewise immaterial."

Residence and Domicile

An individual domiciled in Texas comes into the State of New York some time during the year. He first stays at a hotel and then rents an apartment under a lease and resides here for the balance of the year. To what extent, if any, is he subject to the New York State income tax?

Every resident of the state is subject to the tax. The term resident includes, first, any person domiciled in the state except one who does not maintain a permanent place of abode within the state, who does maintain a permanent place of abode without the state, and who does not spend more than thirty days of the taxable year within the state (sec. 350.7).

The term resident also includes a person who maintains a permanent place of abode within the state and who spends more than seven months of the year within the state, regardless of where his domicile may be. Such a person is taxed as if he were domiciled in New York.

If this individual has established a legal domicile in New York he is subject to tax as a resident under the first part of section 350.7, from the moment he became domiciled in New York.

While domicile may be defined as the place where one lives, legally the term means something more than that. It really means the establishment of a residence plus an intention to make that residence permanent. If this individual has established a new domicile in New York it means that there has been an intent to change his domicile, an actual removal to the new domicile, and a new abode. What constitutes domicile is a question of fact. Every person has only one domicile, although he may have more than one residence.

If this individual has not abandoned his old domicile, then he may be subject to tax under the "seven months" rule. While the law states that such a person is taxed the same as though he had been domiciled in the state during the entire taxable year, this individual had no place of abode until he arrived in New York and, therefore, he would be treated as a non-resident until he first established residence for seven months.

Change of Residence During Year

If a taxpayer changes his status from that of a non-resident to that of a resident he must file two returns, one for each status. On the non-resident return the taxpayer is taxed only on income from sources within the state. On the resident return he is taxed on income from all sources, both within and without the state.

Exemptions are prorated between both returns according to months. There is a rather peculiar provision in the law that where two returns are filed for one taxable year the taxes due shall not be less than would be payable if the total income shown on both returns were included in a single return. Two returns are also required if a taxpayer changes his status from a resident to that of a non-resident.

Unincorporated Business Tax— Who Is Taxable

Several questions have been submitted on the taxability of salesmen's commissions to one who is engaged in

a small business on his own account and who also is employed on a commission basis in a kindred line. Sec. 386 of Article 16A defines an unincorporated business. This section reads in part as follows:

"It is not intended * * * that an individual shall be deemed to be so engaged with respect to compensation for services rendered by him as an employee * * * unless such compensation constitutes receipts of a business regularly carried on by such individual."

It is the opinion of this editor that commissions earned as an employee would not be subject to the unincorporated business tax. If the taxpayer is an employee, and not an independent agent, his commissions are not received in connection with a business regularly carried on by him.

In *People ex rel. Wittich v. Browne, et al.*⁵ an individual acted as sales representative for six separate corporations. The taxpayer contended that he was an employee of the several companies. It was held on the facts that the taxpayer was subject to the tax on the ground that he was engaged in his own business of supplying sales services to companies contracting for it. He was held to be an independent contractor. Ordinarily an employee is accountable to the employer both as to the method in which his affairs are carried on and the results obtained. Some such control may be exercised even in the case of an independent contractor as this case indicates. It becomes a matter of degree. Generally the independent contractor has the freedom to produce a given result without more than a minimum of control by the one for whom he is acting.

Unincorporated Business Tax— Real Estate Business

A member asks whether a partnership or individual operating a piece of real estate with no other business income is subject to the unincorporated

business tax. Section 386 reads in part as follows:

"It is not intended that an individual, partnership or other entity, other than a dealer holding property primarily for sale to customers in the ordinary course of his trade or business, shall be deemed engaged in an unincorporated business solely by reason of the purchase and sale of property for his own account or that an owner, lessee or fiduciary shall be deemed so engaged solely by reason of the holding, leasing, or managing of real property * * *."

It is the intention of the law to exempt such real estate activities from this tax. This is further indicated in question 23(a) of the regulations. If a portion of the premises were used by the taxpayer in connection with a business carried on by him then the rental income received by him would be subject to the unincorporated business tax. In such a situation the rental income is not received solely by reason of the holding, leasing, or managing of real property. Question 23c of the Regulations clearly indicates this interpretation of the law.

Filing an Income Tax Return on December 31st

Does New York State permit the filing of a return on the last day of the year? Sec. 371 of the law provides that a return shall be made to the Tax Commission on or before the fifteenth day of the fourth month following the close of the fiscal year. If the fiscal year has been closed on December 31st, the filing of a return on that day would seem to come within this provision. The Tax Commission has in the past considered returns filed on December 31st as valid returns. Of course the taxpayer contemplates a deduction from gross income of the current year in filing his federal return. To obtain this deduction on the cash basis the tax must be paid in the current year. Consequently the state tax should be paid by certified check. Otherwise the tax will not be deemed to have been paid until the check has cleared the bank.

⁵ 270 App. Div. 774; aff'd., 296 N.Y. 720 (1946).

Accounting at the S. E. C.

Conducted by WILLIAM W. WERTZ

Extensions of time for filing reports under the Securities Exchange Act

Since well before the war S.E.C. has been extremely liberal in granting extensions of time for filing annual and other reports (10-K's primarily) under the 1934 Act. In Release 4196 the Commission announced that it felt many of the reasons for that policy had ceased to exist and that henceforth it would grant extensions only where the application set forth substantial grounds for a delay in filing. Moreover, where delay will be involved only in preparing a portion of the report, it will be ordinarily expected that the remainder will be filed on time and an extension granted only as to the particular part which cannot be filed on time. Applications for extension which fail to give substantial reasons for delay will be denied "as a matter of course."

Amendments to General Rules and Regulations under the Securities Exchange Act of 1934

Effective January 17, 1949, S.E.C. announced in Release 4194 an assortment of changes in its General Rules

WILLIAM W. WERTZ, formerly Chief Accountant of the S.E.C., is now associated with Touche, Niven, Bailey & Smart, C. P. A's.

Mr. Wertz is a graduate of Yale University and of Yale Law School, and is a member of the Connecticut Bar. He was formerly an instructor of accounting at Yale University and Yale Law School. He was also an accounting consultant to the O.P.A. and the Treasury Department.

Mr. Wertz is the author of numerous articles which have appeared in technical accounting publications.

and Regulations. Many of the changes are to delete obsolete material or to include in the General Rules matter formerly found in the forms. In addition, however, the new rules abolish an inequity of condition that theretofore existed as between companies having securities listed on a national securities exchange and those which were not so listed but which nevertheless were required to file annual reports because of a prior sale of securities under the 1933 Act. This latter group of companies must now file interim reports, quarterly reports of sales, and monthly reports on Form 8-K where certain events listed in that form occur within the month. Most companies heretofore filing annual reports on the MD series of forms will now have to file 8-K's and quarterly sales reports.

The following rule covering signatures on accountants' certificates in connection with statements incorporated by reference makes clear a point often overlooked:

"Rule X-12B-36. Use of Financial Statements Filed Under Other Acts.

"Where copies of certified financial statements filed under other Acts administered by the Commission are filed with an application or report, the accountant's certificate shall be manually signed or manually signed copies of the certificate shall be filed with the financial statements. Where such financial statements are incorporated by reference in an application or report, the written consent of the accountant to such incorporation by reference shall be filed with the application or report. Such consent shall be dated and signed manually."

The rules also restate the circumstances under which financial statements may be incorporated by reference from one filing to another even where the filings are under different Acts—a real short-cut when both a 1933 and 1934 filing must be made.

Changes in rules under the Securities Act of 1933 — "Significant" subsidiary test now 15%

Effective January 17, 1949, the following important changes were announced in Release 3322:

"Rule 405 defines the term 'significant subsidiary' to include a subsidiary whose assets, or the investment in and advances to such subsidiary by the parent and the parent's other subsidiaries, exceed 5 percent of the assets of the parent and its subsidiaries on a consolidated basis. The rule also includes as a significant subsidiary any subsidiary whose sales and operating revenues exceed 5 percent of the sales and operating revenues of its parent and the parent's subsidiaries on a consolidated basis. Since the Commission has adopted elsewhere in its rules and regulations tests of significance on a higher percentage basis, it is deemed appropriate to revise the definition of 'significant subsidiary' in Rule 405 to accord with the higher tests of significance employed elsewhere in the rules and regulations. Accordingly, the definition of the term 'significant subsidiary' in Rule 405 is amended to read as follows:

'Significant subsidiary. The term 'significant subsidiary' means a subsidiary meeting any one of the following conditions:

'(a) The assets of the subsidiary, or the investments in and advances to the subsidiary by its parent and the parent's other subsidiaries, if any, exceed 15 percent of the assets of the parent and its subsidiaries on a consolidated basis.

'(b) The sales and operating revenues of the subsidiary exceed 15 percent of the sales and operating revenues of its parent and the parent's subsidiaries on a consolidated basis.

'(c) The subsidiary is a parent of one or more subsidiaries and, together with such subsidiaries would, if considered in the aggregate, constitute a significant subsidiary.'

"Rule 409 permits a registrant to omit from the registration statement or prospectus required information which is unknown and not available without unreasonable effort or expense. However, the registrant is required to give such information on the subject as it possesses or can acquire without unreasonable effort or expense and to state the sources thereof. Heretofore, the registrant has been permitted to disclaim responsibility for the accuracy or completeness of the information so given. Since under the Act the registrant is liable for the accuracy of all information con-

tained in the registration statement or prospectus, the disclaimer provision in the rule has misled some persons into believing that the inclusion of a disclaimer operates to relieve the registrant of such liability. The Commission has determined that the disclaimer provision serves no useful purpose and should be eliminated from the rule. Accordingly, paragraph (a) of the rule is hereby amended to read as follows:

'(a) The registrant shall give such information on the subject as it possesses or can acquire without unreasonable effort or expense, together with the sources thereof.'

The change in Rule 409 was discussed in the *September* issue.

Amendments to Form S-1

Final action, effective January 17, 1949, on the amendments discussed in the *September* issue was announced in Release 3323. The Amendments to items 25, 26, 27, 30 and 32—the remuneration and management items—appear to be as previously described. In addition, the following change has been made in item 8 (information as to capital securities):

"Item 8 calls for information as to the capital securities of the registrant. Where the registrant has subsidiaries which have outstanding securities, such securities ordinarily constitute a claim on the assets of the subsidiaries prior to that of the holders of securities of the registrant. This item has been interpreted as requiring, in the interest of full disclosure, information as to securities of the subsidiaries. In order that all persons using Form S-1 may be advised of this interpretation, Item 8 is amended by adding to the instructions a new instruction reading as follows:

5. Information as to be included as to the securities, other than those owned by the registrant, of all subsidiaries whose financial statements are filed with the registration statement on either a consolidated or individual basis."

Miscellaneous

Failure of a broker to file the financial statements required by Rule X-17A-5 under the 1934 Act has been held to be a wilful violation (and so presumably a basis for revocation of registration) even though the broker was advised by counsel that the reports did not have to be filed. *In the matter*

of James Benjamin Wheeler, Rel. 4200, Securities Exchange Act of 1934. Under the circumstances, however, the Commission found it consistent with the public interest to permit the broker to withdraw his registration.

The difficulties and uncertainty inherent in seeking to determine the fair value of a large aggregate of assets is most interestingly illustrated by the following quotation from a memorandum opinion of S.E.C. in the matter of Portland Electric Power Company (H.C.A. Release No. 8712):

"When this matter first came before us in 1944, we made a careful survey of PEPCO's assets and liabilities. We arrived at \$22,273,646 as the fair value of its assets (apart from the law suits) as of December 31, 1942. Its funded debt amounted to \$16,305,200 principal, plus \$8,559,155 ac-

rued interest. No interest had ever been paid on the bonds, which had been issued in 1935 under a prior Section 77B reorganization. The present Chapter X proceeding was filed in 1939. At the time of our first opinion and order in 1944 it appeared that the company was insolvent in the strict bankruptcy sense. Because the initial plans were unsatisfactory and because pending litigation delayed the liquidation, we had occasion again to review the company's financial condition as of October 31, 1945. We then approved a valuation of the assets at \$40,000,000, which was enough to satisfy the bonds and prior preference stock in full and to leave a substantial equity for the first preferred stock. PEPCO was no longer insolvent in the strict bankruptcy sense."

Somewhat the same uncertainty may even be present in estimating how much is needed to replace existing assets in addition to what is provided as a result of depreciation based on cost!



The Old Order Changeth

(Continued from page 117)

insurance companies in this matter. A plan could be devised whereby the employing accountants and the staff members would contribute to the over-all pension fund as required by the insurance company.

Unless considerable thought is given to this subject by forward-looking public accountants, and well-publicized steps are taken to assure ambitious accounting-minded young persons that

middle and old age will not find them entirely dependent on their personal savings and the meager governmental social security benefits, the corporations which have established pension and other welfare plans will attract those who are considered to be most desirable by practicing public accountants. It therefore behooves all employers to note with Tennyson that, "The old order changeth, yielding place to new."



PROFESSIONAL COMMENT

By EMANUEL SAXE, C.P.A.

Concepts of Income

The second part* of Mr. George D. Bailey's 1948 Dickinson Lecture before the Harvard Graduate School of Business Administration appeared under the foregoing title in the November, 1948, issue of the Harvard Business Review. It deals with "the refinements of the principles applicable to presentation of earnings" and, in that connection, discusses two problems of current importance.

The first of these is a consideration of the question of whether the "exclusive" or the "all-inclusive" concept shall prevail; that is,

"whether the statement of net earnings for the year shall be pointed to a figure showing the results of operations for the year, or whether the statement primarily is to be the channel and the only channel whereby all items of income get into the accumulated earnings of the company."

The second deals with the question of whether accountants should attempt to reflect the impact of changing conditions in annual earnings statements prepared by them, thus sharpening the presentation for purposes of interpretation.

I

It is Mr. Bailey's opinion that the all-inclusive doctrine is dangerous; that its continuance has decidedly impeded progress towards sharp income determination; and that the real problem is "how to establish criteria and standards to make the exclusive theory more useful."

He traces the historical abuses that buttress the argument for the all-inclusive theory, beginning with the decade of the lush twenties when all non-recurring items (principally charges)

were excluded from earnings, which were stated on a more or less "reconstructed" basis. The stock market collapse, followed by the depression of the early thirties focused attention upon the evils attendant upon this practice, and the SEC put an end to it. World War II added additional adjustment matters to the controversy, centering around the problems of reserves.

Next, Mr. Bailey reviews the positions taken by representative bodies. The Committee on Accounting Procedure of the American Institute of Accountants has promulgated Bulletin No. 32, which states the

"presumption that all items of profit and loss recognized during the period are to be used in determining the figure reported as net income. The only possible exception . . . would be . . . items which . . . are materially significant in relation to the company's net income and are clearly not identifiable with or do not result from the usual or typical business operations of the period."

The SEC has recently indicated its disinclination to go along with this doctrine and has publicly reserved the right to require changes in all presentations under this Bulletin which are not acceptable to it or its staff. The American Accounting Association has consistently upheld the all-inclusive theory.

Since Mr. Bailey rejects the all-inclusive theory, he indicates how he would handle the excluded items. He would have the income statement end with earnings for the year, and would have the excluded items show up clearly in surplus. [Bulletin No. 35 (October, 1948) adopts this viewpoint.] As to the companion problem—how to

* The first part was reviewed in these columns in our December, 1948, issue at pages 921-2.

treat the figures of prior years—he concludes that

"the policy of excluding certain items from the determination of net earnings for the year seems to me almost to require a showing of earnings for several years, including adjustments where appropriate for excluded items."

II

In the first section of this lecture, Mr. Bailey wrote about the effect of disturbed economic conditions upon accounting, with particular reference to the problems of reserves for future price declines and depreciation on current replacement cost. He indicates that many people believe that the accounting of today tells the story of corporate earnings inadequately and that, therefore, it should be changed or supplemented to correct this. Both the inflationary effect of prices upon profits and a very high level of business activity during 1947 and 1948 have also accentuated the need for corrective measures.

The most pressing problem, he says, is to learn more about business income and find out what concept of income is best for corporate reporting, and reference is made by him to the study currently being undertaken under the direction of the American Institute of Accountants. Mr. Bailey notes the difficulties inherent in the admixture of the accounting, tax, legal and economic concepts of income presently "interwoven into one fabric of reporting of earnings."

It is Mr. Bailey's belief that "the problems of freeing reporting from distractions caused by the tax or legal theories are not too difficult . . ." and he cites examples of required changes in the tax law to remove any existing interference with proper income reporting, as well as points of conflict with the law, in general, which might also be eliminated.

It is the problem of dealing with the impact of economic forces which gives Mr. Bailey the most concern. He says:

"Accounting can easily accept and reflect any one concept which will be generally

applied by business and which will have support of economists and statisticians, as well as business, provided there can be general criteria against which to test judgment both in the application of the concept and its measurement, and provided further that the new concept will be applied in an orderly way and over a long period of years. But neither accounting nor business can afford a policy designed for one year only, or for years of high profits only, or to be applied at the whim of a company."

He also urges quite strongly that any change of concept on earnings be equally reflected on the balance sheet through the use of generally acceptable index figures for purposes of conversion of old book values to current ones.

In conclusion, Mr. Bailey cautions the profession against advocacy of expedient and pragmatic economic concepts. He reminds us that only a sincere conviction that our present method of reporting income is wrong should motivate the development of new theories and methods. Once this need is felt by all concerned, he believes that it should not be long before cooperative effort by the interested groups will produce the desired result.

The profession should be deeply grateful to Mr. Bailey for preparing this scholarly and thought provoking paper. The highest compliment that might be paid him in this connection would be its studied consideration and wide discussion by all of our members.

* * *

New York Stock Exchange Release on the Reporting of Earnings

The following letter, recently sent out by Mr. Emil Schram, President of the New York Stock Exchange, should be of considerable interest to our members and readers:

**"NEW YORK STOCK EXCHANGE
Eleven Wall Street**

"Office of the President

January 10, 1949

"To the Presidents of Corporations having securities listed on the New York Stock Exchange:

"The method of determining and reporting net income has been and is continually being
(Continued on page 130)

COMMITTEE ACTIVITIES

The following response to a recent inquiry was prepared by our Committee on Cooperation with Credit Men. By reason of its general interest, it is reproduced herewith, for the information of our membership and readers.

Mr. T. W. Kling
c/o National Office Management
Association
12 East Cheltenham Avenue
Philadelphia 44, Pennsylvania

Dear Sir:

Your letter of September, 1948, addressed to Wentworth F. Gantt, Executive Secretary of the New York State Society of Certified Public Accountants, with reference to the use of Accounts Receivable Ledgers by Credit Managers, was referred to me, as Chairman of the Committee on Cooperation with Credit Men. I in turn referred the questions raised by you to five members of our Committee, whose practice and experience are with the larger industrial organizations where the Credit and Accounting Departments are separately organized and have a considerable volume.

The following appears to be the consensus with respect to the questions raised by you:

- (1) *What is the general practice for Credit Managers' use of the Accounts Receivable Ledger sheets?*

When situations require it, the Credit Managers and their assistants may have free access to the Accounts Receivable Ledgers, but the Credit Department personnel are not allowed to remove a ledger sheet or a ledger from the accounts receivable department. Some companies, on the advice of their auditors, limit the access to the Accounts Receivable Ledger by the Credit Department, but furnish them with copies of the monthly open item statements of customers' accounts, as pre-

pared by the Accounts Receivable Department. Procedures are adopted by some whereby the accounts receivable bookkeepers delete from the statements the applicable amounts represented by daily receipts from customers.

- (2) *Do Credit Managers have free access to them or are controls provided to prevent collusion?*

Wherever Independent Public Accountants are called in to render an opinion upon the financial statements of the company, their audit of the internal control procedures would require them to determine the extent to which such internal controls would prevent collusion. Some of the internal control procedures that would be looked for would be:

- (a) that remittances are not routed through the Credit Department, but would be listed by personnel not connected with the Credit Department and further controlled by duplicate deposit slips;
 - (b) that predetermined daily totals of the debit and credit postings from the various original sources are made by the internal auditor, and these are compared with the totals of the Sales Journals, Cash Receipt Books, etc.;
 - (c) that credit memos for adjustments and allowances and write-off of bad debts should not originate in the Credit Department, and should be summarized monthly and submitted in writing to the Board of Directors or a sub-committee of the Directors.
- (3) *Do larger companies furnish Credit Managers with other records from which collections are made?*

Many companies have adopted the procedure whereby the Credit Department is provided with copies of the monthly open item statement of customers' accounts, as prepared by the

Accounts Receivable Department. In some cases, the internal auditor test-checks these monthly statements. The Accounts Receivable Department also advises the Credit Department of collections by deleting items collected from the open items statements, or such data are obtained from memoranda prepared by the cashier. However, the most common practice appears to be that the Accounts Receivable Department maintains a system whereby the accounts which were not paid on the due date are currently ascertainable, and the Accounts Receivable Department notifies the Credit Department that such accounts have not been paid. In some instances, the procedure is that the Accounts Receivable Department will advise the Credit Department if remittances with improper or questionable deductions have been received.

- (4) *Should the Accounts Receivable be under the direction of the Credit Managers in order to speed up efficiency in collection?*

It seems to be the consensus that the Accounts Receivable should not be

under the direction of the Credit Managers, even though it might appear that collections would be facilitated. Under a proper system of internal control, checks and balances are provided for one department as against another. The Credit Department checks against the Accounts Receivable, and vice versa. By merging these two departments, these checks would be lost. After all, the Credit Department is concerned mostly with accounts which have not paid their bills when due; and if it obtains this information regularly and completely through the methods discussed above, it would seem to be unwise to burden it with a record-keeping responsibility also.

I hope that the above will help clarify the questions you have raised; and if there is anything further we can do, please do not hesitate to call upon us.

Very truly yours,

JOSEPH GETZ, *Chairman,*
Committee on Cooperation
with Credit Men

Professional Comment

(Continued from page 128)

studied by various interested groups. It is recognized that the reporting of earnings within the confines of a single year necessitates the exercise of judgment and the results, as reported, are based upon opinion of the management, supported by the opinion of its independent accountants as expressed in their certificate on the basis of objective accounting standards.

"Due to the rapid price changes which have occurred over the past few years, there is a variety of opinion in relation to reporting net income or making appropriations of net income to be considered, particularly those relating to inventories and fixed assets. It would appear that until such varied opinions have become reconciled, the primary figures of the earnings or earnings per share reported to security holders and the investing public should be the net income for the year determined in accordance with generally ac-

cepted practice at the present time. It would then appear logical to include such other information concerning the need for the retention of earnings to maintain a continuing business enterprise as may be desired.

"Your cooperation in following this procedure not only in the text of your annual report but also in any releases which you may make in relation to a report of earnings for the year would be appreciated.

"There is enclosed for your information a copy of Accounting Research Bulletin No. 35, issued by the Committee on Accounting Procedure of the American Institute of Accountants, relating to the presentation of income and earned surplus.

Very truly yours,

EMIL SCHRAM."

The 106th New York Certified Public Accountant Examination

NOVEMBER 17, 18 AND 19, 1948

THEORY OF ACCOUNTS

Thursday, November 18, 1948—9 a. m. to 12:30 p. m., only

Answer eight of the following ten questions.

1 The Jackson Corporation bought a machine on June 1, 1943, for \$5,000, F.O.B. the place of manufacture. Freight to the point where it was set up was \$200 and \$125 was expended to install it. The machine's useful life was estimated at 10 years, with a scrap value of \$50. In June 1945, an essential part of the machine was replaced, at a cost of \$600, with one designed to reduce the cost of operating the machine. On June 1, 1948, the company bought a new machine of greater capacity for \$9,000, delivered, being allowed a trade-in value on the old machine of \$2,000. Preparing the old machine for removal from the plant cost \$75 and expenditures to install the new one were \$225. It is estimated the new machine will have a useful life of 10 years, with a scrap value of \$100 at the end of that time.

Assuming depreciation to be computed on the straight-line basis, prepare schedules showing the amount of depreciation on this equipment that should be provided in the accounts during the year beginning June 1, 1948, (a) under usual accounting theory, (b) under federal income-tax regulations. [12½]

2 In 1925 the K Company purchased for \$75,000, on the open market, 1000 shares of the S Company's common stock, of which more than 100,000 shares were then outstanding. During the ensuing years, dividends were paid regularly and fluctuations in the market value of the stock were relatively insignificant, with a general upward tendency. At the close of the K Company's fiscal year, ended October 31, 1948, the S Company's stock was quoted at 150 and the company's latest annual report for its fiscal year, ended June 30, 1948, shows a book value per share of approximately \$165. Although a manufacturing concern, the K Company has a substantial investment in the securities of other companies which it does not control and in the direction of which it does not participate.

The president of the K Company proposes to increase the asset value of S Company stock on the K Company's books to \$150 per share. Discuss this proposal, indicating how the K Company's financial statements would be affected if it were carried out and the reasons for and against its adoption. [12½]

3 An eleemosynary institution accepts gifts for specific projects, either to establish endowment funds therefor or for direct use in carrying them out.

a In accounting for such gifts, what accounting procedures would you follow in order that in the institution's annual report all pertinent facts would be clearly set forth?

b If the governors of the institution, in order to cover its general administration expenses, borrowed from the monies provided by such gifts for specified projects, how should the facts be reflected in the accounts and in the institution's annual report? [12½]

4 The Inter-Continental Corporation, with its home office in the United States and branches in foreign countries, prepares consolidated financial statements that reflect the assets and liabilities and the operating results in such locations. The accounts of the foreign branches are kept in the respective currencies of the countries in which they are situated.

a Explain the basis of converting the statements prepared in foreign currencies for purposes of consolidation with that of the home office, with respect to

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each of the following items: accounts receivable-trade debtors, sales, factory building, accrued payroll, depreciation of building, home office account.

- b Explain the nature of any difference between the two sides of a foreign branch trial balance after it has been converted to the currency of the home office. [12½]

5 Graves owned 100 shares of the capital stock of the Monaco Mining Company, for which he paid \$5 per share in 1937. Until 1941 he received no return on his investment, but beginning in 1941, he received each year from the company a check for \$250 accompanied by a letter stating that a specified portion of the check represented earnings of the company and the balance was a liquidating dividend. The allocation each year was as follows:

	<i>Earned Dividend per share</i>	<i>Liquidating Dividend per share</i>
1941	\$.75	\$1.75
1942	1.50	1.00
1943	2.50	—
1944	2.00	.50
1945	1.50	1.00
1946	2.25	.25
1947	1.50	1.00
1948	1.00	1.50

Prepare a schedule showing how Graves should have recorded on his books the amount of \$250 received each year from the Monaco Mining Company and at what value his investment in the capital stock of this company should be shown on his balance sheet at the close of the year 1948. Give reasons for your answers. [12½]

- 6 a With reference to the phrase "lower of cost or market" as applied to inventories, state and illustrate (1) the rule for determining "market" under normal conditions, (2) two exceptions to the rule.

b State and illustrate under what conditions, if ever, it is considered proper to state inventories regularly above cost. [12½]

7 The balance sheet of the Williams Corporation at June 30, 1948, included the following items:

5% convertible general mortgage bonds.....	\$2,000,000
Capital stock, 400,000 shares, par \$10 per share.....	4,000,000
Earned surplus	800,000

Under the terms of the bond indenture, the bonds are convertible into stock at any interest date, at the option of the bondholder, on the basis of one \$1000 bond for 100 shares of stock.

On July 1, 1948, Green, a bondholder, converted one hundred \$1000 bonds into stock. Journalize this transaction on the books of the Williams Corporation and explain the theory underlying your entry. [12½]

8 The LMN Corporation was authorized under its certificate of incorporation to issue 10,000 shares of 7% cumulative preferred stock, par value \$100 per share, and 100,000 shares of common stock, par value \$10 per share.

The entire issue of preferred stock was sold for cash at \$110 per share. One half of the common stock was sold for cash at a discount of 20%, the remainder being unissued.

Immediately after the sale of its stock, the company purchased a plant, equipped for operation, for \$600,000.

In preparing the company's balance sheet at the end of its fiscal year, the following suggestions are offered as to the treatment of the discount on the common stock:

- a It should appear as an asset on the balance sheet entitled "Discount on capital stock."
- b It should be included as part of the plant account, without identification.
- c It should be identified as "Organization Expense" and shown as such on the balance sheet.
- d It should be identified as "Goodwill" and so shown on the balance sheet.
- e It should be shown in the Capital section of the balance sheet as a deduction from Common Stock issued.
- f It should be applied as an offset to Premium on Preferred stock and be thus reflected in the Capital section of the balance sheet.

The 106th New York Certified Public Accountant Examination

State which, if any, of the above suggestions you approve for adoption, indicating your reasons for your approval, and state your objections to each of those you disapprove. If none of the above suggestions appeals to you, state, with reasons, how, in your opinion, the discount on common stock should be reflected in the LMN Corporation's financial statements. [12½]

9 Among the assets of the Soya Company, a going concern, are the following:

Trade debtors	\$48,250
U. S. Treasury Tax Notes.....	25,000
Marketable securities (market value \$50,000) at cost.....	42,800

The current liabilities include:

Notes payable to Bank A.....	\$40,000
Note payable to Bank B.....	30,000
Accrued federal taxes.....	35,000
Loan by company's president.....	50,000

The entire amount owing by trade debtors is pledged against the notes payable to Bank A; the United States Treasury Tax Notes will be applied in payment of federal taxes; the marketable securities are held by the president of the company as security for his loan; and the president has pledged 600 shares (par value \$100 per share; book value \$110 per share; no listed market price) of Soya Company capital stock, issued to him, as security for the loan to Bank B.

The treasurer of the company has prepared a balance sheet as of the close of its fiscal year, in which the liabilities stated have been offset against the assets pledged against them in such a way that the excess of a liability over the asset pledged as security for its payment appears as a liability and the excess of a pledged asset over the liability protected by it appears as an asset. Comment on this procedure. [12½]

10 What is "negative goodwill"? Explain the conditions under which it is found and its treatment on the financial statements, indicating at least two methods of presentation and the circumstances under which each would be appropriate. [12½]



COMMERCIAL LAW

Friday, November 19, 1948 — 9 a. m. to 12:30 p. m., only

Except for questions No. 9 through No. 12 in Group II, which are "objective" type questions, reasons must be stated for each answer; no credit will be given for an answer unsupported by a statement of reasons. Whenever practicable, give the answer first and then state reasons. Answers will be graded according to the candidate's evident knowledge of the legal principles involved in the question rather than on his conclusions. Answers to questions involving negotiable instruments, partnerships and sales should be based on the provisions of the pertinent Uniform Law.

Group I—Answer all questions in this group.

1 [10]

- a A makes an offer to B and says, "This offer will remain open for 10 days." B rejects the offer the next day, but accepts it within a week. Is this a contract? Why?
- b A offers to sell B 100 tons of steel at a certain price. B replies "I accept your offer. I hope that, if you can arrange to deliver the steel in weekly instalments of 25 tons, you will do so."
- (1) Is this a contract? (2) Why? (3) Explain. (4) What is A's position as to the instalment deliveries?

2 Answer the following questions in accordance with the Uniform Partnership Act: [10]

- a A and B were partners. The partnership agreement provided it should continue for 10 years. At the end of one year, B seriously neglected the business of the partnership. What, if any, remedy has A?
- b A, who is in the trucking business, is the owner of two motor trucks marked No. 1 and No. 2. A made an agreement with B, who is the driver of truck No. 2, that he (B) should receive as his compensation one-half the net

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profits of truck No. 2, after payment of costs for repairs, gasoline, etc. The other truck (No. 1) ran over and injured C through carelessness of its driver. C sues A and B as partners.

(1) Can C recover? (2) Why?

c A and B are partners. The partnership and both partners individually became bankrupt. The partnership assets will pay only 20% of the partnership debts. How should the court allocate the assets of the partnership and those of the individual estates for the respective creditors? Explain.

d The partnership agreement being silent on the subject,
(1) Where should partnership books of account be kept?
(2) Has a partner a right to copy any of them? When?

3 Answer the following questions in accordance with the Uniform Sales Act: [10]

a Crosby, a miller in Minneapolis, sold a carload of flour to Smith and delivered the flour to the N. P. R. R. to be transported to Smith in Albany, payment to be made in 30 days. When the flour arrived at Albany, Smith, the buyer, rejected it because of bad quality. Crosby, the seller, refused to take back the flour. A few days after Crosby's refusal, the flour being still in the freight car, Smith made an assignment for the benefit of creditors. Crosby then sought to get back the flour and demanded it from the railroad company. Smith's assignee also demanded the flour.

(1) Who was entitled to it? (2) Why?

b M sold goods to X, which he warranted to be of a certain grade. X refused to accept the goods because they failed to answer the warranty. The goods remained in possession of M.

(1) Can X maintain a suit against M for breach of warranty? (2) Explain.

c A, by telephone, ordered from B machinery to be specially constructed for A's use and which only he could use. The agreed price was \$3,000. The machinery was constructed as agreed, but A refused to accept it and, when sued, pleaded the statute of frauds.

(1) Was A's defense good? (2) Why?

4 The president of a corporation engaged a public accountant to examine the books of the company and make a report thereon to the company. Answer the following: [10]

a Who is liable for the accountant's services, the company or the president? Explain.

b What is the status of the public accountant's engagement and what rules of the law govern such relations?

c What are the rights of public accountants to retain copies of letters written by them or the originals of letters written to them in connection with their work, copies of tax returns prepared by them, copies of their reports relating to their audits and examinations and their work papers?

5 On January 1, 1941, X Corporation completed a plant and equipped it for the manufacture of iron castings. The land on which the building was erected cost \$50,000, the building cost \$200,000 and the machinery and equipment installed cost \$100,000. For the purposes of computing straight-line depreciation, X Corporation determined that the building had an economically useful life of 40 years and the machinery and equipment a life of 10 years. The net income from operation of X Corporation for the calendar year 1947 was \$60,000. On December 31, 1947, the entire assets were sold. X Corporation received \$187,000, of which \$60,000 was paid for the land, \$100,000 was paid for the building, \$15,000 was paid for machinery and equipment, and \$12,000 was for the final inventory, the cost of which was \$10,000. In regard to federal taxes: [10]

a What was the effect of the sale on the net income of X Corporation for 1947? Why?

b Did the sale affect the taxable income of X Corporation for any other years? Why?

Group II—Answer five questions from this group.

6 [10]

a Smith delivers goods to a warehouseman and receives a negotiable receipt for them. Jones recovers a judgment against Smith and seeks to levy on Smith's goods in possession of the warehouseman.

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- (1) Can he do so? (2) Explain.
- b In the absence of agreement, a warehouseman insures the goods stored in his warehouse that belong to his customers. He charges them for the insurance premiums, which they refuse to pay.
- (1) Is it his duty to insure? (2) Can he collect the insurance premiums from them?
- c Allen bought tung oil delivered to him in 50-gallon drums. The sales contract stipulated that, after the use of the oil, the drums were to be returned to the seller and, if not returned, \$5 was to be paid for every drum not so returned. As to the drums,
- (1) Was this a sale or a bailment? (2) What was the \$5 stipulation?
- 7 [10]
- a Adrian is surety for Burt for \$10,000. Burt defaults and the surety, Adrian, is sued by the creditor. He settles for \$8,000 and then sues Burt for the full amount of \$10,000. Can Adrian recover \$10,000? Explain.
- b Does discharge of the principal in bankruptcy release the surety? Explain.
- c Where the surety and the debtor both give collateral to the creditor for the debtor's debt and the debtor defaults, may the creditor then resort to the collateral of either at his option? Explain.
- 8 [10]
- a (1) What is the test to determine insurable interest in property insurance? (2) When must a person have an insurable interest to recover under an insurance contract in (a) fire, (b) marine?
- b A corporation insures the life of its president for \$50,000. Thereafter, the president retires, sells his stock interest and has no further connection with the company. The company continues to pay the annual premiums.
- (1) On the death of the insured, is the corporation entitled to the \$50,000 insurance? (2) Why?
- c A has a judgment of record against B, which became a lien against the only parcel of real estate owned by B. B dies, leaving an insolvent personal estate. A obtains a fire-insurance policy for his own benefit on the building of B, which is thereafter destroyed by fire. A puts in a claim for insurance, which the insurance company refuses to pay. A sues.
- (1) Can he recover? (2) Why?

9 Tympany, Inc. is engaged in the retail jewelry business. It keeps its books on an accrual basis and uses a calendar year. During 1946, Tympany sold \$50,000 worth of watches and rings, in payment for which \$35,000 was received in 1946 and the balance during the first three months of 1947. In April 1947, John Jones, one of the 1946 customers, returned a ring which he had purchased as a diamond ring, but which his ex-fiancée insisted was a zircon. Tympany refunded John Jones the amount of the price, \$2,000, although denying that any misrepresentation had been made. Thereafter, Jones sued the company for \$100,000 damages, alleging that Tympany had misrepresented the stone he purchased and that he had suffered grave emotional harm as a result. Tympany settled the suit in April 1948 by paying Jones \$100.

Write the letters *a, b, c* in a column and opposite each letter put the number preceding the alternative that correctly completes the corresponding statement; i.e., if under *a* the correct answer is \$50,000, you would show the figure (1) opposite the letter *a*. No comments are required. The statements relate to federal income taxes. [10]

- a In its federal income tax return for 1946, which was filed March 15, 1947, Tympany should have reported gross income of (1) \$50,000
(2) \$35,000
- b As a result of Jones's suit for \$100,000, Tympany should have (1) filed an amended return for 1946, including as a cost of business the \$100,000 claimed by John Jones (2) deducted \$100,000 as a cost of business in 1947
(3) taken no account of the claimed amount in its return for either year
- c The \$100 paid to Jones in settlement of the litigation is an expense for (1) 1946 (2) 1947 (3) 1948

10 Allen Numbers is a certified public accountant. He has always reported his income on a cash basis and has used a fiscal year ending July 31. Mrs. Numbers has a small income from a trust established by her father. She has always reported on a cash basis and used a calendar year. Among Mr. Numbers' clients is the X Corporation,

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which hired him January 1, 1945, to review all the books of account and trace the necessary stock transactions to make a complete report of the corporation's equity invested capital as defined in sub-chapter E of chapter 2 of the Internal Revenue Code. Mr. Numbers received a retainer of \$50 per month from January 1, 1945 to April 30, 1948, when the report was completed, and on the latter date received a final payment of \$8,000.

Write the letters *a* and *b* in a column and opposite each letter put the number preceding the alternative that correctly completes the corresponding statement; i.e., if under *a* he must report the \$8,000 all as income for the fiscal year in which received, you would show the number (1) opposite the letter *a*. No comments are required. The statements all relate to federal income taxes. [10]

- a* In his return for the fiscal year ending July 31, 1948, Allen Numbers
(1) must report the \$8,000 all as income for the fiscal year in which received
(2) may elect to pay income tax on the \$8,000 received April 30, 1948, as if that amount had been received \$200 per month from January 1, 1945 to April 30, 1948
(3) may omit the \$8,000 entirely as not constituting income for the year in which received
- b* For the fiscal year ending July 31, 1948, Numbers (1) must file a separate return
(2) may elect to file a joint return with Mrs. Numbers and thus "split" his income in accordance with the Revenue Act of 1948

11 In June, A and B orally agreed that A should employ B for 10 months beginning next August 1 on a special research job that B agreed to do. On July 1, A told B he had engaged someone else and would not need him.

On your paper list the numbers (1) through (12) and opposite each number write *True* if the corresponding statement is true or *False* if the statement is not true. Answer all parts. No penalty will be imposed for guessing. [10]

- (1) The contract is unenforceable for lack of a writing.
- (2) B may sue A at once.
- (3) If B sues A at once, he may then safely accept other employment without losing his right against A for breach of contract.
- (4) Unless B does sue A at once, he must continue his preparations and be free and ready to perform his side until A's breach becomes actual by the arrival of August 1.
- (5) Unless, on August 1, B was ready to start work for A, he can not sue A after August 1.
- (6) If, before B sues A or takes other employment, A notified B on July 15 that he will employ him after all, A is bound.
- (7) If B sues A at once but dies before August 1, a defense will arise in favor of A.
- (8) If B dies September 1, not yet having sued A, B's administrator may nevertheless sue A.
- (9) If B was under 21, there was no contract.
- (10) B could get a decree specifically ordering A to perform.
- (11) B could assign his prospective salary to C.
- (12) C, by accepting an assignment of the salary from B, would be promising by implication that he would do the work.

12 Wishing to acquire a site for its factory without provoking a rise in the price of land, the P Company employed A, a real-estate broker, to secure lots without disclosing that he was acting for P. A got a contract in his own name to buy X's lot, giving X a negotiable note for \$500 signed by A as first payment. Considering that SA would succeed better with Y for Y's lot, A employed SA for that purpose and SA signed a contract to buy Y's lot. In fact Y's lot was not contiguous with the other lots P was acquiring, and therefore not within the actual authority given by P to A. Unaware of this, P wrote both A and SA, approving of the purchases.

List the numbers (1) through (5) and opposite each number write *Yes* or *No* to the corresponding question based on the foregoing situation. No comments are necessary. No penalty will be imposed for guessing. [10]

- (1) Is the P Company liable to X on the note?
- (2) Is the P Company liable on the contract to buy X's lot?
- (3) Is the P Company liable to Y on the contract to buy Y's lot?
- (4) Would SA have to take the Y lot himself?
- (5) Would the concealment of P's identity and purposes, which had a bearing on the value of the land, have been alone enough to prevent P from enforcing either the X or the Y contract?

AUDITING

Friday, November 19, 1948—1:30 to 5 p. m., only

Answer all questions.

1 Outline a procedure for the use of an independent auditor who is verifying cash on hand in a department store at the close of its fiscal year, under the following conditions: [15]

- a Cashier receives all payments by charge customers and records them through a cash register.
- b Cashier has a petty cash fund for sundry operating disbursements.
- c Cashier keeps a record of all change funds. The change funds are of fixed amounts and each salesperson has her own fund.
- d Cash sales are recorded by the salespeople through cash-register machines.
- e The store's auditor has the keys to the cash registers. At the close of the business day, the auditor pulls the cash-register tapes.
- f The auditor, on the next day, prepares a report of the cash-register readings (indicating the cash sales recorded by each salesperson) and sends the report to the accounting clerk.
- g At the end of each day the salespeople bring their change bags to the cashier's office. The change bags include the day's cash-sales receipts as well as the fund amounts.
- h Before he leaves the office, the cashier prepares the day's receipts for the deposit that is made on the following day.
- i An independent auditor is present on the last day of the fiscal year.

2 A client operated a chain of 12 retail drug stores. A central office and warehouse also were maintained, where all accounting was performed. The perpetual inventory records, maintained at the central office, are kept in terms of unit quantity, total quantity, unit cost price, total cost price, unit sales price, total sales price, and warehouse or retail store location. The inventories, both warehouse and store, were taken by company employees under the supervision of the independent auditor who had prepared the inventory-taking instructions.

The inventories were taken on serially numbered, duplicate-perforated tags. The inventory crews worked in teams of two; one member entered the description and count of the items on the top portion of the perforated inventory tag; the second member verified the description and count of the items on the lower portion of the inventory tag and then compared his recording with that of the first member.

The auditor and his assistants tested the inventories at the central warehouse and at the retail stores, and after being satisfied with the accuracy of the inventory descriptions and physical count, ordered the lower portion of the tags removed and returned to the central office. At the central office, the description and count were transferred to classified inventory sheets. The items then were priced at the lower of cost or market, were reduced for damaged or obsolete merchandise, and extended and footed. The classified inventory sheets then were transferred to inventory summary sheets and were totaled by company employees.

Under the circumstances outlined, as auditor, what procedure would you follow to verify the inventory? [10]

3 The president of the Ajax Hardware Company, the customers of which are retail stores and building contractors, will not permit you, in your annual audit, to confirm customers' balances by correspondence. The company also does a substantial cash business with small contractors. The cashier is in charge of the company's bookkeeping and has one assistant who substitutes as cashier during the cashier's lunch hour. Charge customers are billed monthly and are allowed a discount of 2% if they pay their bills by the 10th of the month following purchase. A 5% discount is allowed on cash purchases.

Assume that you have reviewed the company's system of internal control over sales and have determined that sales clerks prepare invoices or sales slips for all sales and that these invoices are properly entered in appropriate sales registers. Footings in sales registers and cashbook have been tested.

- a Outline the procedure you would follow in auditing the company's accounts receivable to satisfy yourself, in so far as possible, that the accounts receiv-

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able at the balance-sheet date are authentic accounts and that there have been no irregularities in the transactions with customers.

b Considering the conditions set forth, could you render an unqualified certificate? Discuss briefly. [15]

4 The Magazine Publishing Company (having approximately 30,000 subscribers) accepts subscriptions to its monthly publications to begin with any issue and to extend for periods of one year, two years, three years and five years. The sales price of subscriptions for periods of one year and more than one year are in the following ratios:

1 year	— 100%
2 years	— 180%
3 years	— 240%
5 years	— 300%

Assuming a manually operated system of records, prepare an audit program for use in verification of unearned income from subscriptions as of the end of the company's fiscal year. [15]

5 Base your answers to the following on the data below: [15]

a Prepare a columnar worksheet analyzing the account for the year; show transactions, adjustments and final balance at September 30, 1948.

b Journalize such adjustments as are needed to correct the investment account of the F Company at September 30, 1948.

In an interim examination of the accounts of the F Company for the calendar year 1948 you find the Investment account as follows:

1948		Ref.	Dr.	Cr.
Jan. 1	Balance brought down		\$108,936	
Jan. 31	Sold A stock	CB		\$10,682
Mar. 31	Bought B common	VR	12,125	
June 30	Dividend on C common	J	10,000	
July 31	Sold C common	CB		8,750
Aug. 31	Sold D bonds	CB		22,500
Sept. 30	Interest on E mortgage	CB		350

Reference to the audit working papers of the preceding year shows that the balance at January 1, 1948, consisted of the following:

A Company common:	
1000 shares bought in June 1940 @ \$10 per share.....	\$ 10,000
2000 shares bought in August 1942 @ \$8 per share.....	16,000
1500 shares bought in May 1945 @ \$11 per share.....	16,500
B Company common:	
2000 shares bought in January 1946 @ \$16.50 per share.....	33,000
C Company common:	
100 shares bought in August 1941 @ \$73 per share (par \$100).....	7,300
D Company 5% General Mortgage bonds:	
Twenty \$1000 bonds bought July 1944 @ 98.4 (interest dates F and A)	19,680
E Company Chattel Mortgage on machinery:	
Five per cent \$7000 mortgage taken in September 1947, in settlement of account receivable	6,456
	<u>\$108,936</u>

Your examination discloses the following:

In January 1948, 1000 shares of the A Company common stock bought in May 1945 were sold for \$10,682, net of brokerage.

In March 1948, 500 shares of B Company common stock were bought @ \$24 per share plus brokerage, for \$12,125.

In June 1948, the C Company paid a 100% stock dividend—common on common.

In July 1948, the F Company sold to its president, for \$125 a share, 100 shares of C Company common stock, for which the president gave his check for \$8750 and a letter in which he agreed to pay the balance upon demand of the treasurer of the company.

On August 1, 1948, the D Company redeemed its 5% general mortgage bonds at 110 plus accrued interest.

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In September 1948, the F Company received one year's interest on the \$7000 chattel mortgage of the E Company that it holds.

6 Describe briefly 10 steps an auditor should take to satisfy himself that all of his client's liabilities, either actual or contingent, as of the date of the balance sheet under examination, are reflected in his accounts or otherwise disclosed. [10]

7 The AB Manufacturing Company manufactures a variety of products that range in size and price from small and inexpensive articles to large and costly machines. Its operations are highly departmentalized and its manufacturing expenses are allocated to departments, for each of which an overhead rate has been established.

Explain how you would satisfy yourself as to the correctness of the application of the manufacturing overhead in determining the cost of the various products manufactured and sold. [10]

8 Name five typical expense accounts an examination of which may be of significance in the verification of specific balance-sheet accounts and explain, in each case, the nature of errors in the expense accounts, adjustment of which would affect the balance sheet as of the close of the year in which the entries were made. [10]



PRACTICAL ACCOUNTING—Part I

Wednesday, November 17, 1948—1:30 to 6 p. m., only

Solve all problems.

1 The Waverly Manufacturing Company has decided to change its method of distributing factory burden to its products, all of which are manufactured on special order. You are asked (a) to develop appropriate departmental rates based on the company's operations for the first half of 1948, (b) to illustrate their use by determining the cost of Job Order No. 987 by application of the rates you develop. [25]

The trial balance of the company's factory ledger (cents omitted) for the six months ended June 30, 1948, is as follows:

	Debit	Credit
Materials and manufacturing supplies.....	\$ 85,321	
Work-in-process—material	86,105	
Work-in-process—labor	82,872	
Work-in-process—manufacturing expenses	161,480	
Indirect labor	41,740	
Factory rent	2,400	
Insurance—machinery and equipment	4,216	
Compensation insurance	2,486	
Superintendence	6,000	
Factory clerical salaries	4,950	
Machinery maintenance and repairs	31,010	
Depreciation of machinery and equipment	42,800	
Fuel	3,172	
Electricity	2,178	
Manufacturing supplies used	3,617	
Social security taxes	9,210	
Factory office supplies	879	
Miscellaneous factory expense	1,212	
Manufacturing expense applied		\$158,200
General ledger control		413,448
	\$571,648	\$571,648

Additional data:

The manufacturing operations are carried on in three production departments, A, B and C, with the aid of two service departments, numbered 1 and 2. Other data are as follows:

	Total	A	B	C	1	2
Plant floor space.....	30,000	10,000	5000	2000	7500	5500
sq. ft	sq. ft	sq. ft	sq. ft	sq. ft	sq. ft	sq. ft
Number of employees.....	109	50	20	4	25	10
Number of labor hours.....	113,360	52,000	20,800	4160	26,000	10,400
Number of machine hours	47,952	31,912	9640	560	5840	
Salaries and wages.....	\$161,317	\$76,180	\$28,472	\$9975	\$37,230	\$9460
Cost of machinery and equipment.....	\$1,019,047	\$623,225	\$250,960	\$20,210	\$112,862	\$11,790
Annual depreciation rates.....		8%	8%	10%	10%	20%

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In developing burden rates, expenses not distributed in the above table shall be distributed to departments as follows:

On the basis of floor space:

Factory rent	Fuel
--------------	------

One-fourth of electricity

On the basis of salaries and wages:

Compensation insurance	Social security taxes
------------------------	-----------------------

Compensation insurance
Superintendence
Social security taxes
Factory office supplies

Superintendence	Factory office supplies
Manufacturing supplies used	Miscellaneous factory expense

On the basis of investment in machinery and equipment:

Insurance—machinery and equipment

Machinery maintenance and repairs

Three-fourths of electricity

Factory clerical salaries and \$4,500 of indirect labor are charged to Department No. 2. The balance of indirect labor is charged to Department No. 1.

No. 2, the balance to all other departments on the basis of machine hours.

Expenses of Department No. 2 are to be distributed to Departments A, B and C, on the basis of labor hours.

The departmental burden rates are to be based on machine hours for Departments A and B and on labor hours for Department C.

Data applicable to Job Order No. 987 are as follows:

Material \$487.92; direct labor \$465

Machine hours: Department A, 50 hours

Department B, 12 hours

Labor hours: Department B, 12 hours
Department C, 20 hours

2 From the information below, prepare a monthly cash budget for AB Trading Company for the three months ending March 31, 1949: [20]

AB Trading Company purchases merchandise on terms of 2/10, n/60, and regularly takes discounts on the tenth day after the invoice date. It may be assumed that one third of the purchases of any month are due for discount and are paid for in the following month.

The company's sales terms are 2/10, n/30, E. O. M. It has been the company's experience that discounts on 80% of billings have been allowed and that, of the remainder, one half have been paid during the month following billing and the balance during the second following month.

The average rate of gross profit based on sales price is 25%. Total sales for the company's fiscal year ending June 30, 1949, have been estimated at 80,000 units distributed monthly as follows:

July	9%	November	10%	March	6%
August	10%	December	15%	April	7%
September	12%	January	3%	May	6%
October	9%	February	5%	June	8%

To insure prompt delivery of merchandise, inventories are maintained during January and February at 6% of the number of units estimated to be sold throughout the year, while during the rest of the year they are maintained at 10% of that number. The inventories at December 31 and February 28 should be at the levels intended to be maintained during the respective ensuing seasons.

Total budgeted selling, administrative and general expenses for the fiscal year ending June 30, 1949, are estimated at \$312,000, of which \$120,000 are fixed expenses (inclusive of \$24,000 annual depreciation). These fixed expenses are incurred uniformly throughout the year. The other selling, administrative and general expenses vary with sales. In total, these expenses amount to \$192,000 or 12% of total sales for the year. Expenses are paid as incurred, without discounts.

It is assumed that at January 1, 1949, merchandise inventory, at the 6% level, will consist of 4800 units, to cost \$72,000 before discount, and the cash balance will be \$112,000.

3 On November 1, 1946, A and B formed a partnership to operate a retail drug store. A contributed cash of \$25,000 and B contributed a store building worth \$25,000 that had cost him \$15,000 in 1940 and with reference to which the allowable depreciation from the date of purchase to November 1, 1946, was \$3500. The partnership adopted

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the cash basis of accounting and a fiscal year ending June 30. Both A and B were on a cash basis and used a calendar year. The partnership agreement provided that A should receive a salary of \$360 a month, B a salary of \$300 a month, and that the net profit after deduction of salaries should be shared equally.

For its first fiscal year ended June 30, 1947, the partnership had net profit after salaries of \$6000, of which \$1000 represented a long-term capital gain. The partnership distributed \$2000 each to A and B and retained the balance in the form of increased inventory. The partnership continued in operation during the remainder of 1947 under the same agreement.

The following four statements pertain to federal income tax matters arising out of this partnership. Write the letters *a, b, c, d* in a column and then, opposite *each* letter write the *number* preceding the alternative that correctly completes the corresponding statement; i. e., if under *a* the correct answer is \$13,500, you will show the figure (1) opposite the letter *a*. Answer *all* four parts. No comments or computations need be submitted with your answers. [5]

- a* Upon formation of the partnership, B realized a long-term capital gain of (1) \$13,500 (2) \$10,000 (3) \$25,000 (4) \$0 (5) correct answer not given
- b* The partnership was required to pay tax on (1) \$6000 (2) \$5000 (3) \$10,280 (4) \$11,280 (5) \$0 (6) correct answer not given
- c* The partnership ordinary net income for the fiscal year ended June 30, 1947, was (1) \$10,280 (2) \$11,280 (3) \$6000 (4) \$5000 (5) correct answer not given
- d* In his personal income tax return for 1947, A was required to report as his distributive share as ordinary income from the partnership (1) \$5380 (2) \$6320 (3) \$4880 (4) correct answer not given



PRACTICAL ACCOUNTING—Part II

Thursday, November 18, 1948—1:30 to 6 p. m., only

Solve problem 1 and either problem 2 or problem 3.

1 From the information below, prepare a columnar worksheet, reflecting therein each of the following: [30]

- a* The transactions and adjustments that must be recorded on the books of both the branch and the home office
- b* The assets and liabilities of the branch as at September 30, 1948
- c* The related income data, for the year then ended, that will be required for the state franchise report

The Phoenix Branch, an outlet of Ace Mart Co., receives its merchandise from its out-of-state home office at an interoffice billing price determined at 133⅓% of cost at home office shipping point. Branch inventories are carried on the branch books, at the interoffice billing price.

The Phoenix Branch is required to file a separate state franchise report and for this purpose inventories are to be based on cost at home office shipping point without regard to transportation costs.

The trial balance, before closing, of Phoenix Branch of Ace Mart Co. as at August 31, 1948, appears below:

	Dr.	Cr.
Cash	\$ 13,930	
Imprest cash fund	200	
Notes receivable	8,000	
Accrued interest income, October 1, 1947	190	
Accounts receivable	18,000	
Inventory, October 1, 1947, at interoffice billing price	12,000	
Sales		\$ 56,200
Sales returns	2,500	
Sales allowances	3,815	
Shipments from home office and other branch (at interoffice billing price)	61,840	
Freight in	3,064	
Home office merchandise account		61,840
Home office current account		11,309
Selling expenses	2,910	
Administrative and general expenses	4,150	
Interest income		1,230
Total	<u>\$130,599</u>	<u>\$130,599</u>

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The X Society, a fraternal order that operated Z County Hospital for indigent members of the community, donated it, on September 1, 1947, to the village of H, in which it is located. The gift included all of the securities in the endowment fund (the hospital's principal source of income), as well as the real estate, equipment and other assets. Since the village had made no appropriation for the operation and maintenance of a hospital, gifts from public-spirited citizens supplemented the endowment fund income to provide for operating costs during the first year of its operation by the village, which coincided with the village fiscal year. No part of the principal of endowments may be used for operations. Before the end of the year, preparations were underway for a drive to raise funds to enlarge and improve the plant. Since no money was collected in connection with this drive during the year under consideration, all expenditures for plant improvements were paid out of the general fund, but will be reimbursed from the proceeds of the drive. The following transactions occurred during the first year:

CONTRIBUTIONS AND RECEIPTS

(1) Hospital site—value	\$ 25,000
(2) Hospital buildings—value	200,000
(3) U. S. Treasury bonds contributed as endowment, principal amount...	100,000
(4) Accrued interest on U. S. bonds at August 31, 1947.....	1,250
(5) Stocks and bonds contributed as endowments (no accrued dividends or interest)—market value	1,300,000
(6) Equipment—value	60,000
(7) Life insurance policies assigned to hospital as endowments—	
Cash value	5,000
Face amount	150,000
(Hospital to pay future premiums)	
(8) Contribution from Z County for hospital operations.....	10,000
(9) Contributions from numerous individuals for hospital operations.....	20,000
(10) Proceeds from sponsored charity bazaar.....	500
(11) Interest received from U. S. Treasury bonds.....	2,500
(12) Dividends from stocks.....	44,000
(13) Interest from bonds, other than U. S. Treasury.....	12,000
(14) Sale of stocks included in endowments at \$27,000.....	52,000

DISBURSEMENTS

(15) Building improvements	20,000
(16) Equipment	15,000
(17) Salaries	15,000
(18) Food and dietary supplies.....	10,000
(19) Medicinal supplies	20,000
(20) Life-insurance premium paid.....	2,000
(21) Property insurance	5,000
(22) Light, heat and water.....	1,000
(23) Expenses of charity bazaar, announcements, etc.....	15
(24) Other operating expenses	4,000

OTHER INFORMATION

(25) Cash value of life insurance held for benefit of hospital at August 31, 1948	6,500
(26) Contributions subscribed but not collected.....	5,000
(27) Prepaid insurance at end of year.....	500
Balance in bank per bank statement at end of period.....	51,085
Outstanding checks amount to \$3,300 and the last day's deposit of \$1,200 is not included on the bank statement.	
(28) Upon completion of the \$20,000 improvements to the hospital building, it was appraised at \$250,000.	

